

Helping Underserved UK Small Businesses Grow:

How PayPal Working Capital is providing access
to finance in pockets of Great Britain that need it most



Foreword

“Small businesses are the lifeblood of the British economy. Yet many UK entrepreneurs have struggled to get financing to help them develop and grow their businesses. The 2008 financial crisis made matters worse, as traditional lenders reduced their commercial lending.

Fortunately, help is at hand. Companies such as PayPal have pioneered alternative forms of funding that are proving very popular, especially because they make applying for financing far more convenient. This shows how ‘fintech’ brands – innovative companies at the intersection of technology and finance – are transforming the fortunes of customers who have been underserved by traditional financial services. PayPal has now advanced over £400 million to more than 22,000 British small businesses since launching PayPal Working Capital in late 2014.



PayPal commissioned this study to increase understanding of the challenges British businesses face getting funding, and how new forms of financing are making a difference. We were intrigued to find that a third of PayPal Working Capital cash advances have gone to businesses in areas that have lost 50 or more bank branches in the last four years.

Britain has a strong history of innovation, especially in fintech. UK policymakers understand the importance of creating a climate for innovation, with major initiatives such as Open Banking. PayPal will continue to forge partnerships with banks and other organisations to boost access to finance and improve the products available to British small businesses.

We hope this report will create further interest in this critical area. “



Mark Brant
Managing Director of PayPal UK

Executive Summary

While small businesses play a critical role in the global economy, UK businesses have not been immune to the decline in access to financing. The issue became more acute in the wake of the 2008 financial crisis as financial institutions were wary of what they perceived as “risky” investments in small businesses where information asymmetries abound, such as lack of credit history. Moreover, the retail bank branch, the most common location for a small business to apply for financing, was hit hard by the financial crisis.

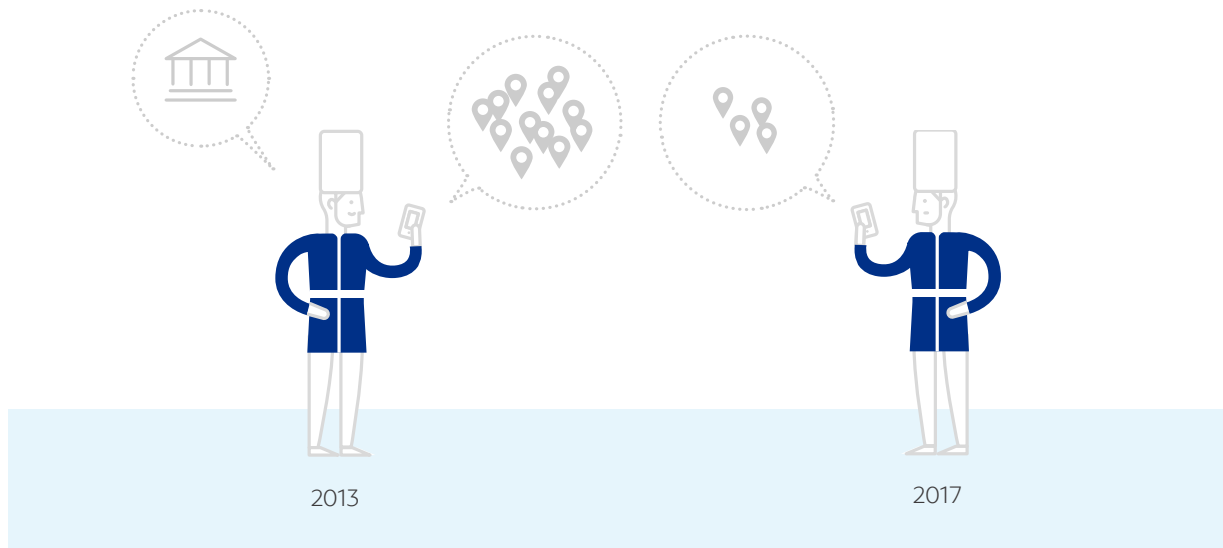
Concurrently, the UK has been centre stage for the rise of innovative technology companies seeking to offer traditional financial services in new ways based upon new user experiences, better data, and faster decision-making. The promise of financial technology, also known as ‘fintech’ – the intersection of technology and financial services² – is to open up new opportunities for those that have access to fewer choices under the financial services market status quo. The onset of online as well as mobile technology means that small business representatives no longer need to visit a bank branch to conduct basic

financial transactions like deposit cheques, make withdrawals or payments, or set up standing orders or direct debits. But when retail bank branches shut their doors, access to finance for many small businesses became more limited, because those services were not easily replicated digitally by high-street banks.



This study demonstrates how PayPal Working Capital is providing small business with access to finance in precisely those places where traditional institutions have pulled back. The implications of this correlation is that services like PayPal Working Capital can be part of the solution to the problem of small business financing that has plagued the UK for years.

The data on the decline of retail bank branches and small business lending by traditional banks are glaring. In order to understand the decline in financing by retail banks we analysed data in Great Britain from the Local Data Company on retail bank branch closures, the British Bankers Association on small business lending by large banks, and the Office for National Statistics on average income levels. All data was analysed at the postcode area level (the largest geographical unit used and the first two alpha digits of the UK postcode).



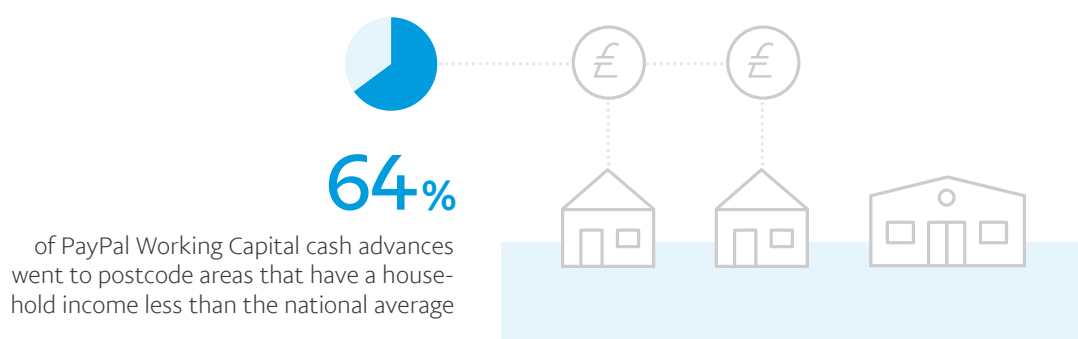
The key findings from our analysis of the government and private sector data was :

- Small business financing by large banks declined by 7.5% or £7.64 billion between Q2 2013 and Q3 2016.
- There are 23 postcode areas that have lost 50 or more bank branches since 2013.
- Lower income regions have experienced disproportionate declines in retail bank branches. Of the 70 postcode areas in the UK with below average incomes, 51 lost bank branches.

The findings from the data helped to frame our inquiry when we looked into PayPal Working Capital. In late 2014, PayPal launched PayPal Working Capital, a merchant cash advance that enables a small business to obtain financing based on its PayPal sales data as part of the underwriting process. We analysed a dataset of over 20,000 UK small businesses that have used PayPal Working Capital.

Here are the key findings from our research:

- PayPal Working Capital cash advances disproportionately go to places where retail bank branches have closed. Over 30% of PayPal Working Capital cash advances went to postcode areas that had lost 50 or more bank branches since 2013.
- The volume of PayPal Working Capital cash advances is greater in areas with larger declines in small business lending by large banks. On average, across the UK, a one percentage point decrease in small business lending in a postcode area is associated with 6.5 additional PayPal Working Capital cash advances in that postcode area.
- Small businesses in the UK seem to be fairly responsive to the closing of retail bank branches by looking to PayPal Working Capital. Our results from simple linear regression analysis suggests that on average, across the UK, each additional 2015 bank branch closure in a postcode area is associated with an 8.15% increase in 2016 PPWC UK cash advances in that postcode area.
- Lower income regions have experienced disproportionate usage of PayPal Working Capital cash advances. 64% of PayPal Working Capital advances went to postcode areas that have a household income less than the national average.



While it is true that other factors [such as Internet access, entrepreneurial nature, etc.] could drive the increased uptake of PayPal Working Capital in places where bank branches have closed, where small business bank financing has declined and which are lower-income postcode areas in the UK, the correlation between the data is striking. It is also notable that we had very similar results when we ran a similar analysis in the US.

We believe small businesses are responding to the challenges in obtaining traditional forms of financing by turning to new online sources.

UK Government data has shown a rise in online financing for small businesses, but this is the first study to show that the rise of online financing is occurring in precisely those places where access to traditional funding sources has decreased.³ PayPal Working Capital is providing a much needed service to small businesses across the UK.

We also believe that the online nature of these businesses is what leads them to succeed despite being located outside of major city centres. Online commerce enables a UK small business to reach customers across the UK and around the world regardless of where they are located. And services like PayPal can help that

small business transact with trust with customers around the world. Access to finance combined with the ease of domestic and cross border payments can help to level the playing field for small businesses across the UK.

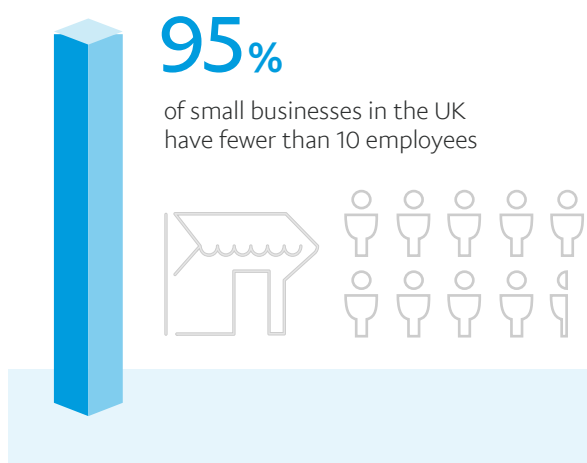
PayPal Working Capital is still in its early days and it will take careful consideration by all stakeholders to ensure that small businesses are able to continue to benefit from the service. Banks will continue to have a major role in small businesses financing, and if banks can partner with technology players there is tremendous potential that can be leveraged.

Technology companies like PayPal will continue to ensure that their products meet the needs of those that are underserved as well as those well catered for by existing players. This study demonstrates that such a strategy is good for society and good for business. Finally, UK policymakers have done a tremendous job in creating an enabling environment for fintech, and must continue to foster fintech innovations that have positive impact on the economy and society.

We hope that this research will create interest in how services like PayPal Working Capital are helping to revolutionise financial services for the underserved in the UK.

1. The Importance of Small Business and Traditional Challenges with Financing

Small businesses are an integral part of the UK economy. They make up 99.9% of private sector businesses in the UK.⁴ Small businesses are responsible for the majority of total private sector jobs.⁵ They are also responsible for about half of the private sector turnover in the UK.⁶



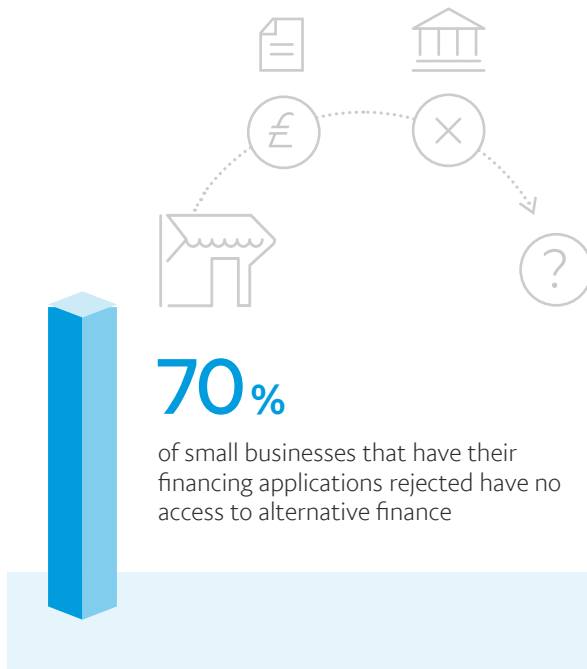
Small businesses are defined as those with fewer than 250 employees and less than 50 million pounds in annual turnover.⁷ The vast majority of small businesses in the UK have under 50 employees.⁸ In fact, 95% of small businesses in the UK have fewer than 10 employees.⁹

Access to finance has been listed by small businesses in the Institute of Chartered Accountants of Scotland (ICAS) report as the number one barrier to growth.¹⁰ Small businesses around the world report similar concerns with access to finance.¹¹

Traditional underwriting methods require paperwork, history, and processes that are often beyond the capabilities of a small business. Thus, many small businesses are either rejected when they apply for financing or choose to sidestep formal financing altogether for fear of getting rejected.

The challenges with small business financing in the UK are nothing new. A 1931 report from the Macmillan Committee identified the challenge of small firms in securing funding, and has since been known as the “*Macmillan Gap*.”¹² A number of government and private sector programmes that have been launched since the Macmillan Committee have yielded success, but the problem of access to finance persists. Micro to small, younger, and higher growth businesses have faced the highest hurdles in applying for financing.

Small businesses without employees and startups seeking financing for the first time also face significant challenges due to information asymmetry – a lack of information on credit history that lenders traditionally use to make investment decisions.¹³



Moreover, these micro-businesses often have very different financing needs from a 200 employee small business, and the finance offerings are often tailored to meet the needs of larger businesses.

Younger and smaller firms are also disproportionately likely to struggle with access to bank financing because they struggle to demonstrate the successful business history often required to obtain financing.¹⁴ Businesses located outside of cities face a paucity of options in applying for financing. In 2013, the Department for Business, Innovation & Skills and HM Treasury reported that 70% of small businesses that have their financing application rejected have no access to alternative finance.¹⁵

High growth small businesses that often have short term credit needs due to expanding business lines, which can result in a challenge for financiers to “turn around” the decision in time.¹⁶

*Challenges with small business access to financing are not evenly spread across the UK ; with those in London and the South east finding it much easier to access capital than those in the midlands and North.*¹⁷

This phenomenon may contribute to higher small business optimism in London and the South than in the North.¹⁸ Moreover, several pieces of research have demonstrated that the profile and financing needs of small businesses in London are different from the rest of the UK because of the city’s large number of high growth companies, tech hubs, talent, and investment.¹⁹

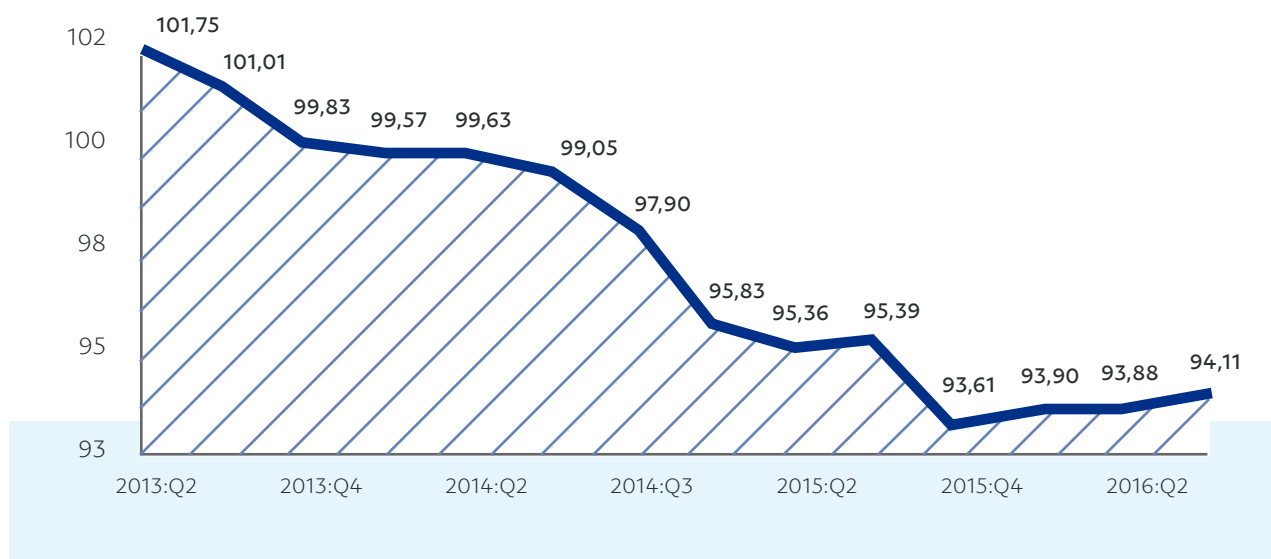
London had double the business density (number of businesses per 10,000 adults) of the North East in 2012, which makes it more difficult for the traditional retail bank branch financing model to work in regions like the North East.²⁰

2. Retail Bank Small Business Financing and Closures in Recent Years

In the wake of the financial crisis small business banking shrunk considerably. The small business funding gap in the UK is estimated at **between 10 and 11 billion pounds**.²¹ Some estimates have even gone as high as 30 billion pounds.²² From 2009-2012, the flow of new bank term-lending to small businesses fell by 23%.²³ The reduction in bank lending also resulted in a lessened expectation of, and interest in, acquiring financing by small businesses.²⁴ Small businesses who are considered “non-seekers” of finance increased by 15% between 2012 and 2015.²⁵

Small business financing overall has largely recovered since the crisis, but large banks have continued to pull back from the segment.²⁶ Small business lending by large banks declined by 7.5% or £7.64 billion between Q2 2013 and Q3 2016.²⁷ The UK’s withdrawal from the EU (Brexit) is expected to further impact the small business lending sector both as a result of economic uncertainty and impact on financial flows.²⁸

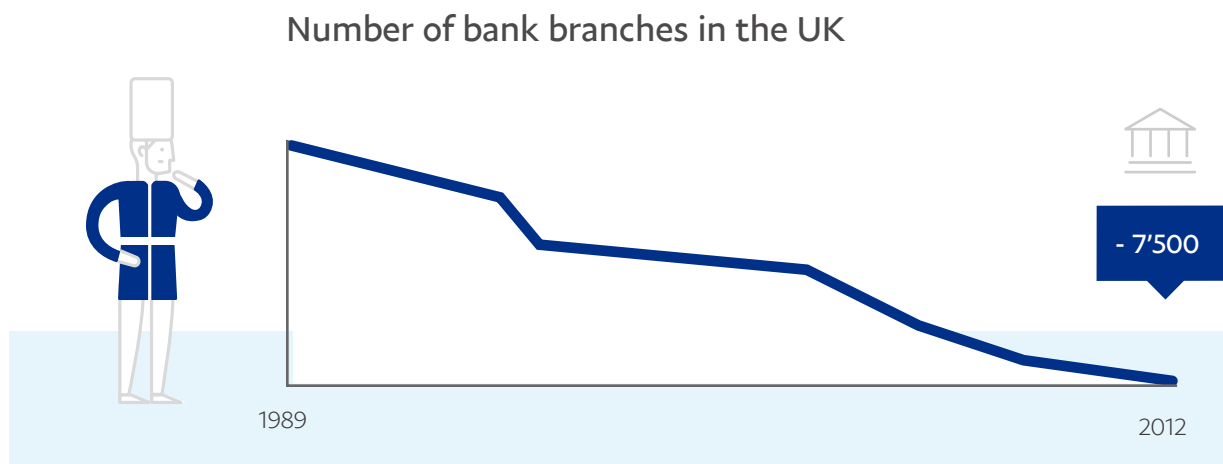
The value of outstanding SME financing by large banks, Great Britain, 2013:Q2 to 2016:Q3 (billions of £)



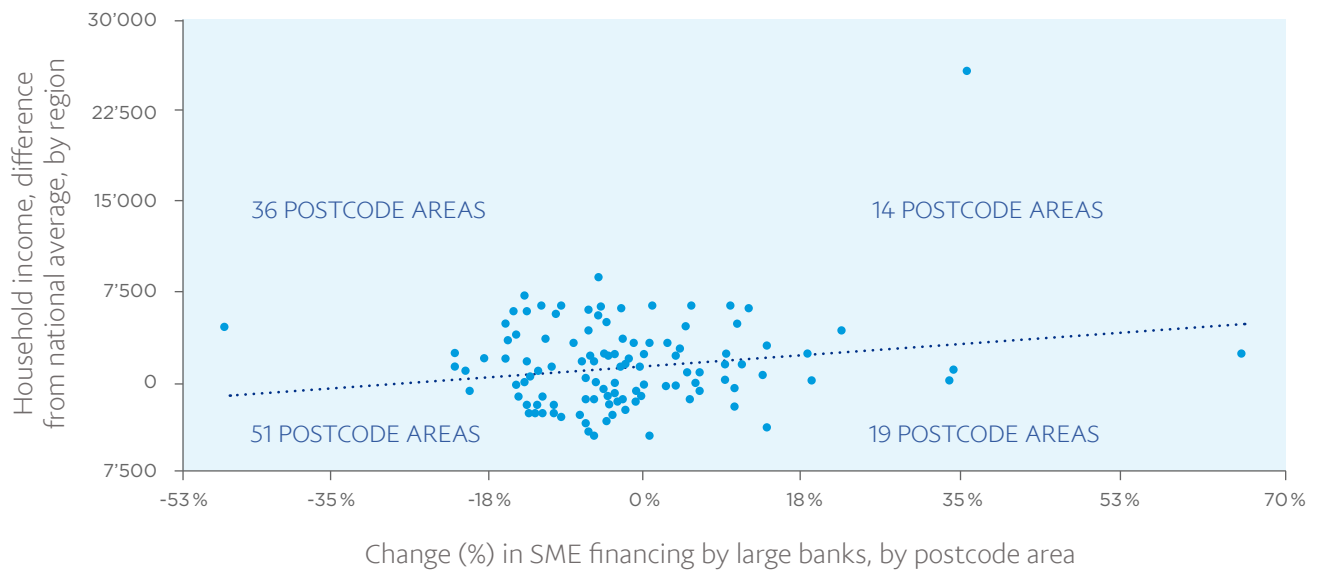
The small business funding gap in the UK is estimated at between 10 and 11 billion pounds.

Research from French et.al at the University of Nottingham demonstrated that the UK lost nearly 7,500 bank branches between 1989 and 2012.³¹ But, the researchers at University of Nottingham also noted that bank closures had slowed down in the early 2000s. In hindsight, we can see that the bank closure slow-down was only temporary. The BBC reported that more than 600 branches were closed between April 2015 and April 2016 by six major UK banks.³² **Our research using data from the Local Data Company demonstrated that there were 23 postcode areas that have lost 50 or more bank branches since 2013.**

Concurrent with the fall in small business lending by large banks has been the closing of retail bank branches by large banks. The four largest banks in the UK have 80% of the business current accounts.²⁹ They are also often the first place that small businesses will go to secure financing, as they often have current accounts at these banks.³⁰ The problem has been that the number of retail bank branches have been declining across the UK since the 1980s, and have seen massive closures since the financial crisis.



SME financing by large banks and household incomes, by postcode area



The researchers at University of Nottingham also found that retail bank closures were not uniform across the UK between 2003 and 2012. They found that areas associated with traditional manufacturing saw 3.5 times higher rates of branch closures than suburban areas.³³ They also found that less affluent areas experienced greater bank closures. The BBC data on bank closures in 2015 and 2016 similarly showed that rural, commuter, and seaside towns were hit the hardest.³⁴

Our research using data from the Office for National Statistics and the Local Data Company showed that lower income regions have experienced disproportionate declines in retail banks. We analysed the datasets by postcode area (the largest geographical unit used and the first two alpha digits of the UK postcode).

Of the 70 postcode areas in the UK with below average incomes, 51 lost banks.

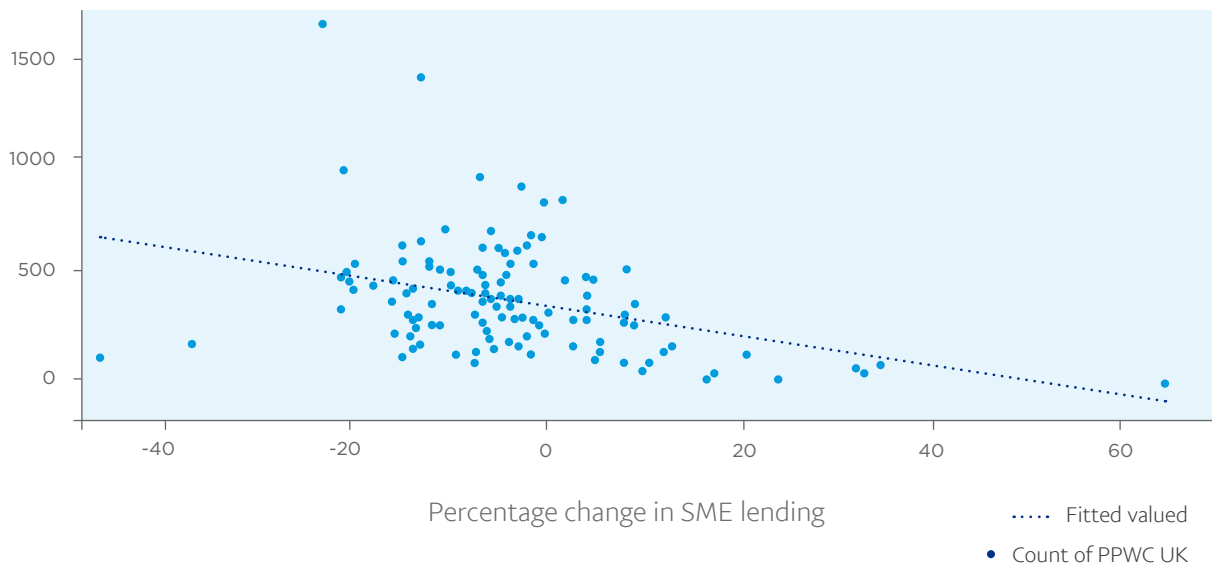
3. The Impact of PayPal Working Capital on Underserved Small Businesses

PayPal Working Capital was launched in the UK in late 2014. It is an innovative product that leverages PayPal sales data as part of the underwriting process. Completing the application takes just minutes and, upon approval, funds can be delivered to the small business in even less time. The business chooses the cash advance amount, selecting a repayment percentage to be drawn from their PayPal sales and pays one fixed fee, with no interest or other fees. Over 20,000 small businesses have used PayPal Working Capital in the UK since it was launched.

We secured a dataset showing bank branch closures by postcode area from the Local Data Company. We then overlaid PayPal Working Capital cash advance data on top of the bank closure data. We saw a positive relationship between bank branch closures and PayPal Working Capital advances. Over 30% of PPWC advances went to postcode areas that had lost 50 or more banks since 2013.



Change (%) in SME lending by large banks and # of PPWC UK cash advances



We also found that the volume of PayPal Working Capital cash advances is greater in areas with larger declines in small business lending by large banks. On average, across the UK, a one percentage point decrease in small business lending in a postcode area is associated with 6.5 additional PayPal Working Capital cash advances in that postcode area.

Small businesses seemed to turn to PayPal Working Capital almost immediately in the wake of bank branch closures. We considered bank closures in 2015 and PayPal Working Capital originations in 2016. Our results from simple linear regression analysis suggests that on average, across the UK, each additional 2015 bank branch closure in a postcode area is associated with an 8.15% increase in 2016 PPWC UK cash advances in that postcode area.

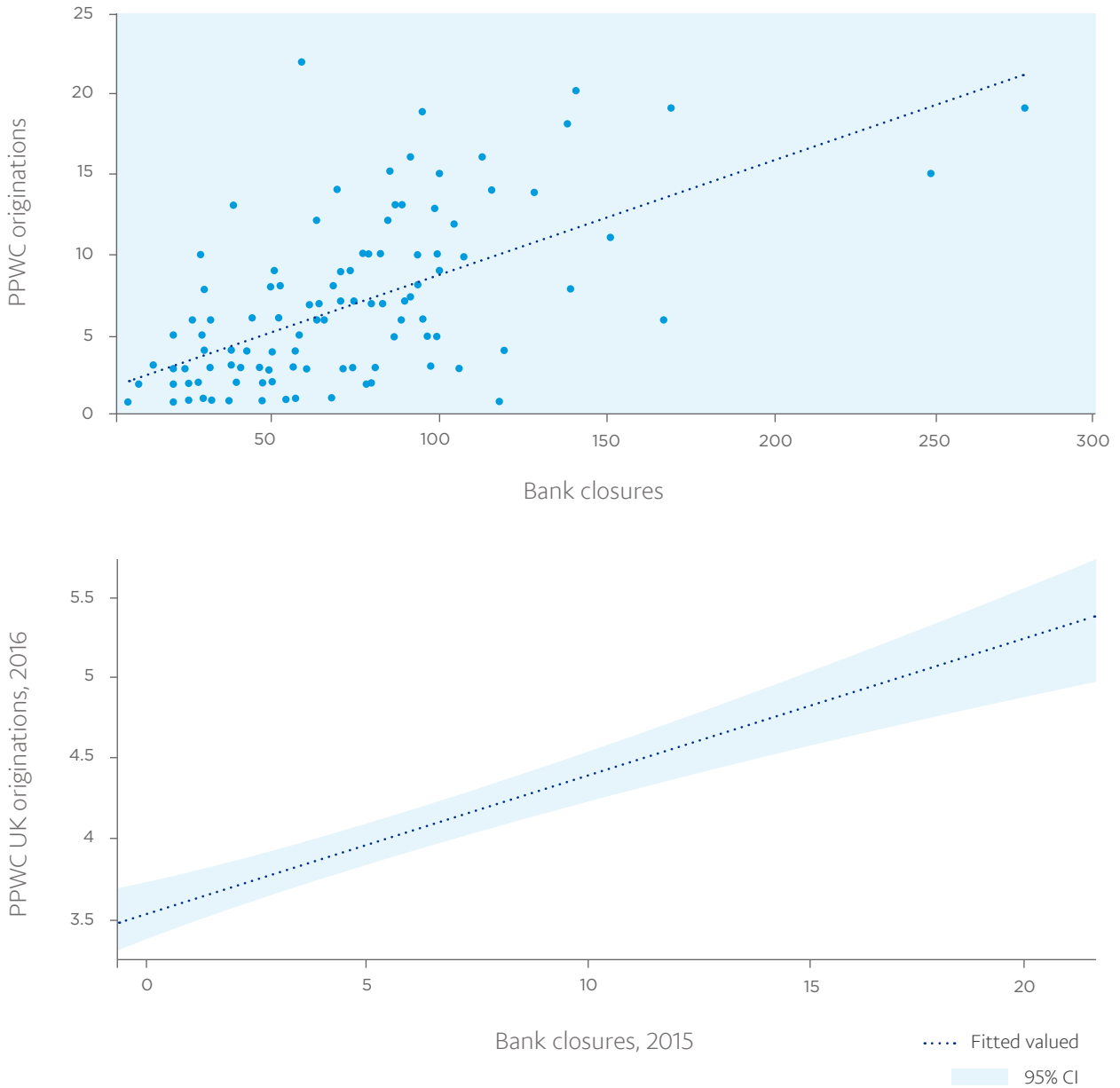


20,000+

small businesses have used PayPal Working Capital in the UK since it was launched



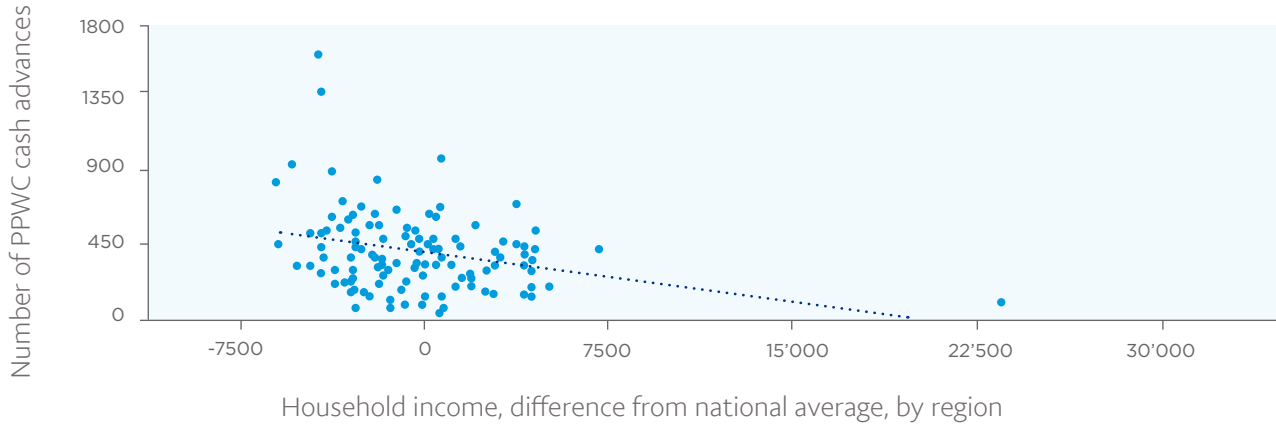
Bank closures in 2015 and PPWC originations in 2016



Finally, lower income regions have experienced disproportionate usage of PayPal Working Capital cash advances. We used data from and the Office for National Statistics on average income levels by postcode area.

We found that 64% of PayPal Working Capital advances went to postcode areas that have a household income less than the national average.

Income levels and PPWC cash advances, by region



There are a few product-related reasons that might explain the impact of PayPal Working Capital on underserved small businesses. Most small businesses need smaller amounts of financing than is typically offered by retail banks.³⁵ The average PayPal Working Capital merchant cash advance is about 8,000 pounds.

The product is linked in with PayPal's payment services and repayments are taken automatically as a percentage of the business' sales. This innovative design can help to lower concerns with late payments and long term debt. 75% of small business owners want to pay down debt and remain debt-

free according to SME Finance Monitor.³⁶ Graydon reported that in 2014, 60% of UK SMEs were experiencing late payments and the total late payment debt owed by SMEs was 39.4 billion pounds.³⁷ Having repayments taken directly as a portion of sales might be a major explanation for the success of the product among underserved small businesses.

There is also the fact that these businesses are online businesses and therefore enjoy the benefits of access to consumers across the country and around the world. A traditional small business would be restricted to the customers who walked by their high street store, or perhaps through targeted supplier relationships.



€8,000

Average PayPal Working Capital merchant cash advance

But, the Internet opens up a wealth of new possibilities, an online store can be created in hours. By partnering with services like PayPal a small business can begin to transact with trust with consumers all around the world.

"Having a child with special needs, at times I have to put that job at the top of my list. My business is to help other people who are in that struggle and to provide a solution. "

Mel Thomsett

Owner & Founder of Sensory Smart Store

PayPal Merchant Case Study:

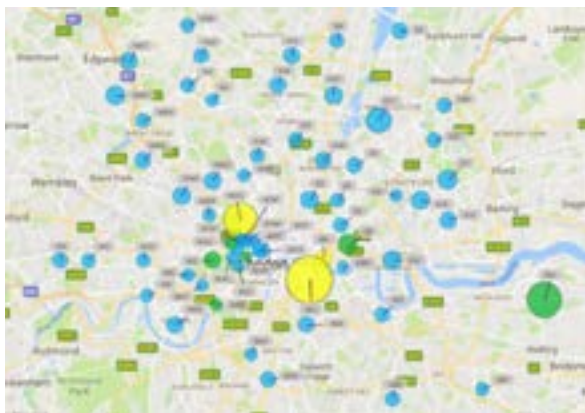
Sensory Smart Store

Sensory Smart Store is a business, based in the New Forest region of southern England, that is dedicated to providing solutions for people with sensory and sensitivity conditions through seamless or 'seam-free' clothing. Mel Thomsett got the idea to start the business through her own personal experience and struggles with sensory processing disorders. When her son was 14 months old, he was diagnosed with autism and sensory processing disorder which made the simplest of tasks, like putting socks on a child, a monumental feat. However, Mel was determined to use this as a reason to launch a project and potentially help others in similar situations. Mel went to her bank of 20 years to apply for £10k in financing, but was denied.

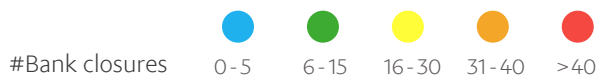
Based on the success of her business through PayPal, Mel got a PayPal Working Capital cash advance to help construct her 'Shedquarters', a small shed on her property out of which she can operate her business. She has since taken out two additional advances which have helped increase her inventory to fill the new space which in turn helped grow her sales. Mel's business has two part-time employees and has grown at about 120% year-over-year selling to customers all around the world. Mel appreciates the flexibility of repaying the advance. "It is all linked to the success of my business." Long term, Mel hopes to use PayPal Working Capital to expand into a larger warehouse space where she can hire adults with autism.

A Deeper Dive

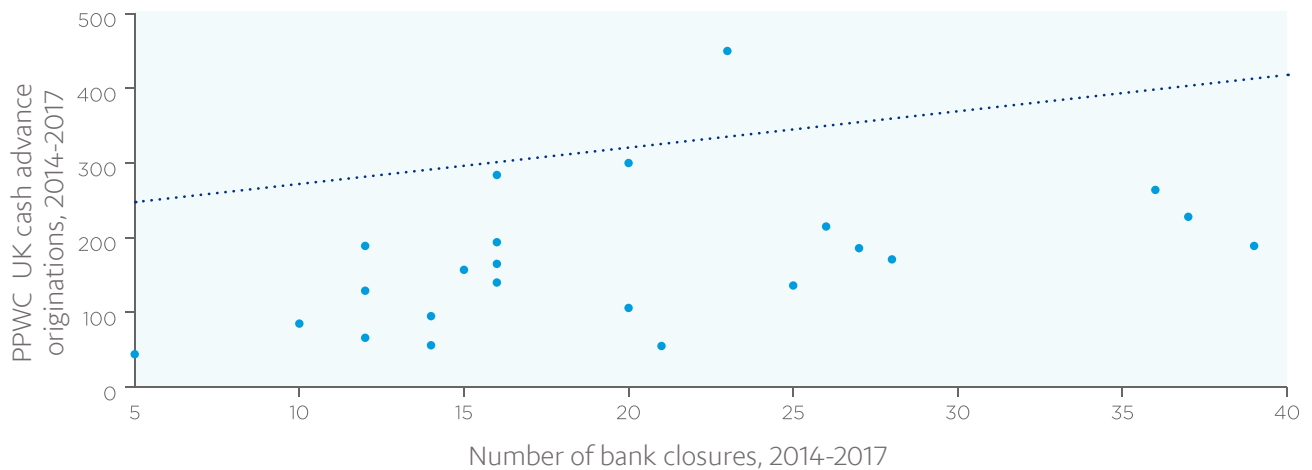
In order to understand the implications of the shift to online merchant cash advances we decided to take a look at two areas of the UK that are particularly noteworthy, London and Scotland. What we found is that our findings in the UK overall held in these two areas. In London, each additional bank closure is associated with 4.7 (nearly 5) PPWC cash advances.



London saw an 11% decline in SME financing by large banks between Q2 2013 and Q3 2016.



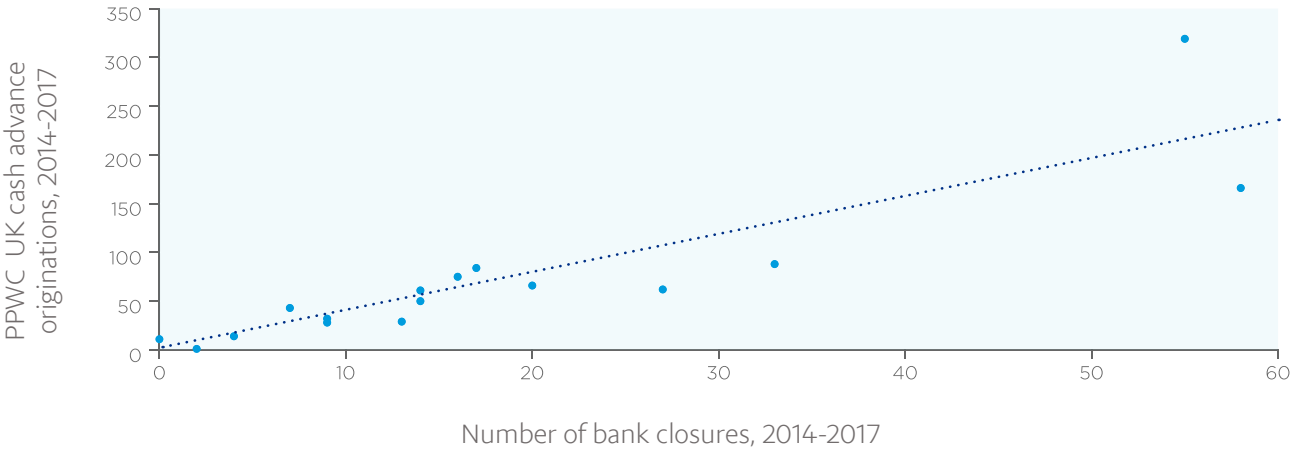
Bank closures and number of PPWC UK cash advance originations, London



For Scotland, each additional bank closure is associated with nearly 4 PPWC cash advances. Moreover, in Scotland, 73.3% of PPWC UK cash advances went to postcode areas with a below average household income level.



Bank closures and number of PPWC UK cash advance originations, Scotland



4. A final note

Many small businesses in the UK are unaware of products like PayPal Working Capital that can help their business grow. Data from the Department for Business, Energy & Industrial Strategy demonstrates that there is more of a financing information gap than a financing access gap – over half of small businesses go straight to their bank for financing and don't shop around.³⁸ GOV.UK has reported that access to information and advice on finance options is a more significant barrier to small businesses than availability of funding.³⁹

Stakeholders that are interested in facilitating the growth of underserved small businesses must come together to increase awareness and enhance solutions. Banks will continue to have a major role in small business financing, and there are tremendous partnership opportunities between banks and fintech companies like PayPal to increase access and improve product offerings.

Policymakers also have a role to play by creating an enabling environment for online financing to grow and by highlighting the opportunities presented by online services to small businesses across the country. UK policymakers and regulators are already taking encouraging steps to address this issue.

One such measure is a 2016 order from the Competition and Markets Authority (CMA) requiring banks to implement '*Open Banking*', enabling more sharing of data, trustworthy comparison of services and timely prompts on branch closures and fee changes, among other items.

This comes on the heels of the UK Government passing the Small Business Enterprise and Employment Act in 2015, which requires banks to refer small businesses to alternative financing providers upon rejecting a financing application.

*The possibility to close the small business credit gap is real.
The technology to reach small businesses across the UK exists.
The financing can be brought to bear and small businesses are desperately in need of growth capital.*

We hope that this report spawns new thinking about how best to provide access to finance to underserved small businesses in the UK.



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³ British Business Bank, Small Business Finance Markets 2016/2017

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