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Impacts of COVID-19: Open Call for evidence and experiences

Response from: School of Management University of St Andrews

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➢ Potential Economic Impacts

I welcome the opportunity to contribute to the Economy, Infrastructure and Skills Committee inquiry on the impact of Covid-19. This submissions wishes to highlight the impact of the crisis for small and medium-sized enterprises (SMEs). The Covid-19 pandemic has created an enormous systemic economic shock, potentially surpassing the one created by the GFC in 2007/08 (Baker et al, 2020). Such is the uniqueness of the current crisis some label it a metaphorical "black Swan event" for entrepreneurship, as it encompasses virtually every sector, every type of business and every country spanning the entire global economy.

Comprehensive evidence suggests the firms likely to experience the greatest impact from shock events are SMEs. SMEs account for 99.4% of the 267,000 active ventures in Wales. Cumulatively, SMEs in Wales account for 62.4% of employment and 37.9% of turnover, with large enterprises accounting for the remainder[1]. How these firms survive, adjust and adapt to the Covid-19 crisis will have an enormous bearing on future economic and societal welfare in Wales.

Extensive research shows that the SMEs are heavily impacted by exogenous shocks owing to their limited capabilities to mitigate these events and withstand the attendant financial instability and uncertainty. SMEs also face problems liquidity problems which occurs when the cash generating ability of the company fails to pay for their current obligations and liabilities. Previous unforeseen events such as the GFC and Brexit cause significant damage and a "wait and see mentality" leads to a lack of adjustment in SMEs. This then results in a large under-investment in growth-related activities such as innovation, capital investment and international activities (Brown et al, 2019a).

Internal sources of finance are crucial for start-ups and SMEs. Our recent work shows that many UK SMEs have very limited spare financial resources and modest precautionary savings (Cowling et al, 2020). This means that many businesses will quite quickly run out of cash reserves thus endangering their continuation and the livelihoods of their dependents.

[1] https://gov.wales/sites/default/files/statistics-and-research/2019-12/size-analysis-active-businesses-2019-503.pdf

Our preliminary assessment of precautionary cash reserves in SMEs suggests that there are potentially 120,000 UK businesses (mostly micro firms with less than 10 employees) at immediate risk of a liquidity crises if they cannot generate a revenue stream for a few months. Furthermore, it is estimated that approximately half a million UK SMEs are already under significant financial distress due to the crisis[2]. This suggests around approximately 5-8,000 Welsh SMEs may be at immediate threat of closure due to a lack of cash reserves, with a further 30-40,000 facing financial distress.

Faced with extreme liquidity issues some SMEs may seek recourse to non-traditional high cost sources of finance such as credit cards as they attempt to meet their financial commitments (Brown et al, 2019b). However, this could hinder or jeopardise their longer-term sustainability if excessive costly lending is undertaken.

Access to external sources of finance are also critical especially for growth-oriented SMEs (Brown and Lee, 2019). Research emphatically suggests access to bank finance becomes more problematic for SMEs during crisis episodes such as the GFC (Cowling et al, 2012; Demirgüç-Kunt et al, 2020). This can result from a combination of reduced supply of leading by banks and reduced demand from SMEs who face chronic uncertainty.

While the vast majority of SMEs use bank finance, innovative start-ups and SMEs often utilise equity finance such as venture capital and business angel finance. Research also suggests that these sources of entrepreneurial finance fall dramatically during crisis and recessionary periods (Howell et al, 2020). Indeed, our work shows that the Covid crisis has dramatically reduced these levels of finance both in China (60% decrease in q1) and the UK (30-40% decrease in q1) (Brown and Rocha, 2020; Brown et al, 2020). This work also shows the deals and firms most negatively affected are seed stage investments in the newest and most nascent start-ups. In other words, the smallest most innovative and growth-oriented firms maybe starved of cash by the crisis with powerful knock-effects on reduced innovation in the longer-term (Howell, et al, 2020).

➢ Types of Firms Most Vulnerable to Shocks

We now wish to examine the types of SMEs most vulnerable to the exogenous shock caused by the pandemic. Inevitably, as with all recessionary periods there will be winners and losers from these unfolding events, irrespective of firm size, age, sector, ownership structure and geographic location. However, there is some strong body of evidence suggesting certain types of SMEs are more at risk from the crisis periods than others. Identifying these firms is a crucial first step so that policy measures can be put in place policy measures to ameliorate these malign effects.

While the crisis will undoubtedly result in business closures, it should also born in mind that business churn within the population of SMEs is an inevitable and positive aspect of the Schumpeterian resource re-allocation process which occurs within economies during

[2] https://www.ft.com/content/f9537538-d7a0-44e3-8e86-5cb9a984aae4

recessions. For example, as some conventional retailers/restaurants go bust due to lockdown measures resulting in job losses, other online retailers and food delivery companies will grow and thrive creating new employment opportunities elsewhere.

Without question the firms facing the most immediate threat from the lockdown are the smallest and least resilient micro-firms employing between 1-9 employees. These are the firms with the weakest cash reserves and lowest capacity to access to external debt finance to ease their liquidity problems (Cowling et al, 2020). Importantly, research also strongly suggests they often face crisis events by becoming discouraged from borrowing as they fear they will be rejected by banks (Cowling et al, 2012).

Start-ups are also heavily impacted by crisis periods (see Kuckertz et al, 2020). This important pipeline of the business stock often need external finance to get their business ventures off the ground. For some conventional start-ups, many rely on their own sources of capital and savings to finance their ventures. However, for more innovative and capital intensive start-ups this self-funded route may not be feasible or indeed practicable. It would appear highly likely that start-ups will be credit rationed during the crisis owing to the likely contraction of both debt and equity finance. A shortage of finance for new ventures is of crucial importance because research shows that start-ups born during recessions not only start smaller, they stay smaller in subsequent years even when macro-economic conditions recover (Sedláček and Sterk, 2017). This means that the future levels of innovation in the economy are also likely to be negatively impacted.

These problems are especially acute for very small and innovative SMEs (Lee et al, 2015). Our research strongly shows that problems accessing bank finance are particularly acute for innovative SMEs who often have limited collateral, intangible IP and unstable cash flows which make banks unwilling to lend to these firms (Lee and Brown, 2017). Innovative firms are also those most likely to self-ration finance for fear of rejection, thereby becoming so-called “discouraged borrowers” (Brown et al, 2018). Given their importance for economic development, enabling access to finance for innovative firms is a crucial policy objective during recessionary periods to enable firms to undertake these strategic investments.

Geographic location also determines a firm’s ability to access finance. In the UK it has been shown that SMEs located in rural and remote parts of the UK face greater challenges accessing bank finance (Lee and Brown, 2017). This owes to a lack of bank branches in these locations and low levels of competition between banks. SMEs often prefer close relational engagement with banks but are often too small to be given access to bank account managers. Plus, following the GFC many banks heavily reduced their customer-facing employees to reduce costs, further exacerbating these problems for rurally located SMEs. Therefore, rural and peripheral SMEs in Wales could be especially hampered by the crisis, especially as many are highly dependent on the travel and tourism sector which has been massively impacted due to the lockdown and reduced travel by tourists.

Turning to the sectoral impacts from the crisis it would appear that localised service-based firms are being most heavily impacted due to the lockdown of large swathes of the service sector such as retailers, pubs, restaurants, tourist-related firms, taxi firms, personal services (hairdressers, nail-bars etc) estate agents, sports clubs and so on. This has resulted in a quarter of UK businesses temporarily closing their business. It is hoped the UK's job retention scheme can alleviate the immediate problems of paying staff salaries. However, some of these firms are unlikely to be able to continue trading without sustained levels of support over the short-to medium term given a reduced level of consumer demand caused by social distancing measures.

It appears that some of the winners from the crisis could be in high-tech sectors such as life sciences, medical equipment, online delivery-based firms, software firms and app-based firms. Some of these firms may be in receipt of venture capital or business angel finance and already have sufficient funding. Others may have funding models which make them resilient to shocks such as computer games companies where they get up-front funding from customers.

Other more prosaic SMEs can also potentially thrive if they adopt new business models and organisational reconfiguration. For example, a traditional local retailer may begin an online delivery service for their customers. These types of SMEs may also attempt various forms of financial bootstrapping to minimise expenditure to endure a fallow period, such as foregoing management salaries, using credit cards, doing agreements with suppliers, renting rather than buying equipment and using personal savings to run a business. However, while potentially crucial to maintain a firm's existence during a crisis period, this form of financial bootstrapping can often result in firms becoming seriously under-capitalised and at risk of closure in the longer-term.

➢ Focus for Support

From the preceding discussion we can see certain types of SMEs may be particularly vulnerable to the Covid-19 crisis with the potential for debilitating consequences in terms of their future viability and future growth potential. We now set out the main firms to be targeted for policy support, the nature of support and then highlight some specific recommendations for interventions to mitigate the impact of the crisis.

We highlighted above that the smallest SMEs, micro-firms and start-ups are likely to be the most heavily impacted. These very small firms also have the least levels of entrepreneurial resilience to absorb the shock. Innovative firms are also susceptible to these problems owing to their difficulties obtaining finance. Similarly, rural and peripherally located SMEs also face additional challenges. The sectoral effects are harder to precisely discern but it appears that locally-focused non-tradeable service-sector SMEs are also particularly susceptible to being impacted by the upheaval from the lockdown and the problems associated with social distancing. In a nutshell, these types of firms need to be considered when constructing Welsh policy support interventions.

In terms of the nature of policy support there seems to be two key dimensions how policy should operate. In the *short-term*, there is a need for a very rapid responses to ensure SMEs can continue operating, ease liquidity constraints and ensure continuity of employment.

This has been the main focus of the main UK government policy measures enacted to date such as the furlough sick pay scheme and the Covid-19 Business Interruption Loans scheme. The former has possibly been the most effective support mechanism for preventing mass business closure. In the *longer-term*, policy support is going to have to focus on a different set of more growth-enhancing measures rather than business survival objectives. Going forward, assisting start-ups, increasing innovation, fostering high growth firms and aiding business internationalisation will be core objectives to help build the recovery process. The types of support instruments emerging in this respect are the UK's Future Fund. In recognition of the potential impact of the Covid-19 crisis for start-ups the government is a Fund with a budget of £250m which provides matched funding of between £250,000 to £5m for UK start-ups[3].

We wish to offer a series of **key policy recommendations** for alleviating the deleterious impact of the crisis for Welsh SMEs based on the issues examined previously. Below are six key policy recommendations:

1).The Coronavirus Job Retention Scheme is probably the single most successful policy instrument enacted by the UK government to mitigate the harmful effects of the crisis. If the scheme ends abruptly for SMEs in August as planned it could lead to extensive business closures thereafter. Consideration should be given to extending the scheme for SMEs in certain sectors of the economy such as independent restaurants, pubs, gyms, personal service firms and tourism-related business until at least the end of the year. Large companies should be excluded from the scheme from August but SMEs in those sectors should be given extended access to the scheme given the likely reduced levels of demand for these type of local services due to social distancing measures. Being a UK-wide scheme the Welsh Government would need to campaign for this step to be implemented.

2).During the post-crisis period, while many SMEs will shrink and cease trading many others will grow rapidly. To ensure that these high growth firms help absorb those made redundant there needs to be a better connection between labour market policies and enterprise support policies. Towards this end, some economists have advocated hiring subsidies to help encourage increases in new employment hires during crisis periods. Cahuc et al. (2019) provide empirical support that a temporary non-anticipated hiring subsidy in France deployed during the GFC had substantial positive employment effects. This could take the form of no social security contributions paid by the employer in relation to their new hires. It could be targeted at SMEs and offered to promote employment expansion in growing firms. Additional incentives could be offered to SMEs hiring unemployed people rather than people within the workforce to increase opportunities for newly redundant workers.

3).While the supply of finance is crucial so is the need for demand. Plus, many SMEs simply do nothing as a consequence of extreme uncertainty. This means firms refrain from seeking external finance because they fear rejections, leading to firms becoming heavily under-capitalised. Therefore, the Welsh government should undertake a major marketing campaign to highlight the range of different support instruments available to SMEs to help

[3] https://www.businessinsider.com/uk-250-million-future-fund-explained-2020-4?r=US&IR=T

alleviate the anticipated increases in discouraged borrowers during the post-crisis period. Another approach would be to offer SMEs free financial advice on different funding sources and financial products which are often difficult to comprehend by time-constrained entrepreneurs. This could be targeted towards innovative SMEs who are often entrenched discouraged borrowers. Access to information about external sources of finance for start-ups and SMEs can be helpful for enabling entrepreneurs to access the right type of financing for their ventures.

4). Most of the support offered by the UK government and the British Business Bank has focused on access to finance for SMEs such as the Coronavirus Business Interruption Loan Scheme[4]. However, survey evidence strongly suggests that during crisis situation SMEs are highly reluctant to take on additional debt for fear that they cannot repay it. Plus, very few SMEs, especially micro-firms employing fewer than ten employees, have precautionary funds to help them adapt during a crisis situation. Therefore, the government in Wales should consider offering small grants to SMEs who wish to undertake new revenue-generative activities. The scheme could offer fast turnaround grants to SMEs who wish to undertake new innovation practices such as business model adaptation. For example, restaurants may start to offer home delivery services. This type of incentivization is crucial to help SMEs adjust to the new realities we are confronting and enable them to remain solvent during a prolonged recessionary period.

5).In terms of support for equity finance, the UK government has already implemented the aforementioned Future Fund. It appears from the initial reactions of equity investors that the seed finance deals are likely to be those most affected which predominantly involve investments for start-ups. Owing to the nature of these funding sources, social distancing could result in financial distancing as entrepreneurs and investors cannot meet up and interact. One novel approach would be for Welsh policy makers to facilitate online engagement between entrepreneurs and private equity investors (i.e. angels) through a secure online meeting place similar to private equity crowdfunding platforms. This novel form of online brokerage could help alleviate the informational problems associated with financial distancing during a crisis such as the Covid-19 crisis.

6). Finally, given the rapidly changing landscape facing policy makers, they will have to monitor their interventions using real-time data sources rather than relying on official government data sources. These are often unofficial data sources which provide up-to-date information on various phenomena. Examples, include things like recruitment agency data on vacancies for estimating labour markets or Crunchbase data for entrepreneurial finance. These types of live data sources can enable policy makers to track how entrepreneurial phenomenon (such as recruitment or entrepreneurial finance) responds during recovery periods following shock events. Using these forms of RTD, countries can also help track the effectiveness of such policy interventions by monitoring future changes in the market for entrepreneurial finance following a crisis period (Brown and Rocha, 2020). Therefore, it can enable *real-time policy evaluation* to ascertain how effectively entrepreneurial actors respond to policy measures implemented to address crisis situations.

[4] https://www.british-business-bank.co.uk/ourpartners/coronavirus-business-interruption-loan-scheme-cbils-2/?gclid=EAIaIQobChMIifbRko2G6gIVme3tCh3VNwr_EAAYASAAEgK8-fD_BwE

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