



A Growth Strategy Report
from
M Institute

Empowering Medium Enterprise

A guide for policy-makers

October 2006



Microsoft®

Introduction

The medium business segment is the growth engine of the UK economy and employs at least 15% of the workforce. Yet, its performance is curiously invisible, hidden as it is in the all-encompassing SME definition. The challenges facing medium organisations are different in scope and degree from those facing small businesses.

The UK government wants to see Britain as the best place in the world to start and grow a business. Yet most of its attention is on policies and measures aimed at start-up businesses. Growing businesses need separate attention.

This report is from M Institute. It is supported by **Microsoft** and the **Institute of Chartered Accountants in England and Wales** (ICAEW). It seeks to focus attention on the medium business segment in order to help define it better, and to assist in identifying actions that can be taken to support the continued economic growth performance of medium organisations.

The report draws on a number of different strands of evidence:

- Continuous reference to the evidence base used by the Small Business Service (SBS) of the DTI
- Extracts relating to medium organisations from the 2005 Enterprise Survey conducted by the ICAEW, covering 1,214 quantitative interviews with business leaders
- Qualitative interviews and discussions with business leaders from twenty medium organisations, reflecting on the results found through the quantitative studies.

It is our intention, as founders of M Institute, that this report helps make Medium Enterprise a segment on its own, distinct from the SME label that is widely used. We intend that it is used by those in government, in particular, to consider the impact of their policy-making on the performance of medium organisations in the UK. We also feel that it will be helpful to those who are either involved in this segment of the market or observe it.

Jyoti Banerjee
Paul Druckman
Kathy Palmer
Founders

M Institute
October 2006

Note on M Institute

M Institute is a not-for-profit organisation created to be a trusted information source and support mechanism for the leaders of mid-sized organisations. It is also their voice in the marketplace.

M Institute Objectives:

- Be the trusted information source through which M businesses can access reliable and validated data, provided by thought leaders in core areas of expertise, all of which are relevant to their scale of enterprise.
- Liaise with government on the issues that are critical and relevant to M businesses
- Deliver a virtual support infrastructure to assist M businesses
- Provide a networking community for M businesses

Find out more at www.m-institute.org.

Table of contents

Introduction	2
1. Recommendations	4
1.1. Recommendations regarding access to finance	4
1.2. Recommendations regarding regional development	4
1.3. Recommendations regarding the burden of regulation	4
2. Executive summary of report	5
2.1. Key themes of the report	5
3. Policy in the M world	8
3.1. Action Plan for Small Business	8
3.2. Application to Medium organisations	8
3.3. Policy stance	9
4. Defining and understanding medium organisations	10
4.1. Size definitions	10
4.2. Size problems	10
4.3. Differentiating medium enterprise from others	11
4.4. Contributions from Medium Enterprise	12
5. Comparative performance of medium enterprise	13
5.1. Sampling the population	13
5.2. Growth comparisons, by size	13
6. Challenges faced by medium enterprise	16
6.1. Key challenges	16
6.2. Policy issues relating to medium enterprise	17
6.3. Challenge I: Access to capital	17
6.4. Challenge II: Regional development	18
6.5. Challenge III: Burden of regulation	19
7. Further challenges in the business environment	23

1. Recommendations

The main policy recommendations of the *Empowering Medium Enterprise* report are as follows:

1.1. Recommendations regarding access to finance

In the area of access to capital, M Institute recommends the following actions from policy-makers:

- Investigate why the longer-term financing model between banks and companies that exists on the Continent is not applied by UK banks
- Create a credit rating scheme for medium organisations. Currently, there are six major credit agencies that dominate the large enterprise segment of the market but with none playing in the medium business sector: clearly, there is an issue of scale involved. It may not be worthwhile for any one of the existing commercial credit rating agencies to push-start a scheme for medium organisations, but government could help remove the imperfect knowledge that currently exists between lenders / investors and borrowers.
- Investigate whether there is need in the UK for a funding agency that supports bank loans and other financing when the main use for the funding is to be innovative or enter new markets.

1.2. Recommendations regarding regional development

Regional development will really work for medium organisations if:

- RDAs are intentionally strategic in choosing the strengths of the region they will focus on, in their efforts to attract inward investment
- As RDAs are relatively unknown among British companies, they need to make a conscious effort to promote their regional strategies to organisations *inside* their region so that the latter can plug into their region's competitive strategies.

1.3. Recommendations regarding the burden of regulation

M Institute recommends three actions in the area of challenge relating to regulation:

- Steady performance by government in reducing the regulatory burden, on the lines of the Dutch model, where new regulation is considered only in the context of old regulations that can be scrapped.
- Simplification of the regulatory environment for medium organisations in particular, as they usually have to deal with regulatory issues on their own without the added infrastructure and manpower that larger organisation can use to deal with such issues.
- Reconsideration of the overall burden of regulation in those industries where there is additional regulation from an industry watchdog, such as in travel and financial services.

2. Executive summary of report

The medium business segment is the growth engine of the UK economy and employs around 15% of the workforce. Yet its performance is curiously invisible, hidden as it is in the all-encompassing SME definition. The challenges facing medium-sized organisations are different in scope and degree from those facing small businesses.

The UK government wants to see Britain as the best place in the world to start and grow a business. Yet most of its attention is on policies and measures aimed at starting businesses. This research study from M Institute, and supported by the Institute of Chartered Accountants in England and Wales (ICAEW) and Microsoft, seeks to focus government attention on the challenges facing medium enterprise, and the actions government can take to support their continued economic growth performance.

2.1. Key themes of the report

Medium business is very different from small and large business

Medium business is different from both small and large businesses in a number of key areas. These differences mean that the challenges they face in the market are different from each other. In many ways, medium business is rather more like large business in its behaviour and characteristics, which makes it even more incongruous that medium business is compartmentalised with small business via the SME definition. The following tables summarises the key differences observed in this report:

Small business	Medium business	Large business
Owner-managed	Owners plus professionals in key leadership roles	Professional management
Micro-management of employees	Empowerment of employees	Freedom to act within corporate guidelines
Informal processes	Formal processes	Formal structures and processes
Short-term planning horizon	Longer-term planning horizon	Short-term results / long-term planning horizon
Low external input	External input from professionals	Governance structure separate from management
Equity held by founder / family	Wider equity base	Diversified equity base
Small customer base	Diversified customer base	Diversified markets with diversified customers
Limited personnel development opportunities	Culture enables employee / management development	Multiple career development paths
Low borrowing requirement – government support possible	Borrowing needed long-term / funding available shorter term	Wide pool of funding sources

Table 1: Behavioural differences by size of organisation, M Institute, 2006

Medium enterprise growth is held back by certain economic factors

Although medium enterprise is a powerful growth creator in the economy, it receives little support or consultation from the government. Neither does it seek or expect any help from anybody. Governmental intervention is not desirable in the marketplace, except in those conditions where the market mechanism is either weak or operating inappropriately. Often, medium organisations do not associate themselves as a grouping and therefore little work has been done to find out their needs.

However, research by M Institute has found that medium businesses do face obstacles to growth that are unique to them because of their scale of operation and due to market failure of some sort

or the other. In certain instances, these obstacles can be addressed by government policy actions without compromising the working of the market. It is these obstacles that are listed below:

Access to capital

Growing a business needs capital. Not every medium organisation has difficulty in raising capital, particularly when the capital is needed for buildings and capital equipment. But capital is difficult to obtain when the driver for finance is growth. Banks have a short-term view on lending which does not support the longer-term requirements of medium business. M organisations believe that venture capitalists have moved up-market so that their need for a return is such that companies have either to deliver a spectacular growth performance or give the investors a higher share of the business than they would like to. Government schemes for finance are aimed at start-up businesses and are irrelevant to medium business.

M Institute recommends the following actions from policy-makers:

- Investigate why the longer-term financing model between banks and companies that exists on the Continent is not applied by UK banks
- Create a credit rating scheme for medium organisations. Currently, there are six major credit agencies that dominate the large enterprise segment of the market but with none playing in the medium business sector: clearly, there is an issue of scale involved. It may not be worthwhile for any one of the existing commercial credit rating agencies to push-start a scheme for medium organisations, but government could help remove the imperfect knowledge that currently exists between lenders / investors and borrowers.
- Investigate whether there is need in the UK for a funding agency that supports bank loans and other financing when the main use for the funding is to be innovative or enter new markets.

Regional investment

The fastest growing regions in the world attract high levels of foreign direct investment. In those regions local businesses, particularly medium businesses, offer skills, services and products that complement that inward investment. British businesses are largely unaware of the focus of inward investment in the regions they operate in, and three-quarters of medium businesses have never heard of the Regional Development Agency (RDA) operating in their region. Consequently, they are not able to take advantage of the growth opportunities available nor are they able to enhance the competitiveness of the region by offering complementary skills and services.

Regional development will really work for medium organisations if:

- RDAs are intentionally strategic in choosing the strengths of the region they will focus on, in their efforts to attract inward investment
- As RDAs are relatively unknown among British companies, they need to make a conscious effort to promote their regional strategies to organisations *inside* their region so that the latter can plug into their region's competitive strategies.

Burden of regulation

Business carries the burden of much of the interchange between government and its citizens, whether administering the relationship between government and its citizens, paying for the policy cost of regulation on safety or consumer protection, or enduring the cost to the economy of ensuring compliance. While small businesses are often exempt from this burden, or outsource the relevant processes to third party specialists, medium businesses pay the price themselves. In certain industries, they report that their costs of compliance are very high because they have to meet the same regulations as large businesses. Such compliance is unrealistic in business terms.

M Institute recommends three actions in the area of challenge relating to regulation:

Empowering Medium Enterprise

- Steady performance by government in reducing the regulatory burden, on the lines of the Dutch model, where new regulation is considered only in the context of old regulations that can be scrapped.
- Simplification of the regulatory environment for medium organisations in particular, as they usually have to deal with regulatory issues on their own without the added infrastructure and manpower that larger organisation can use to deal with such issues.
- Reconsideration of the overall burden of regulation in those industries where there is additional regulation from an industry watchdog, such as in travel and financial services.

3. Policy in the M world

3.1. Action Plan for Small Business

In January 2004, a Government Action Plan for Small Business was published by the DTI aimed at making the UK the best place in the world to start and grow a business¹. The plan identified seven themes which impact economic performance:

- Encouraging entrepreneurial and innovative actions among people going into business
- Building a more dynamic start-up market
- Improving access to finance for small businesses
- Encouraging more enterprise in disadvantaged communities and under-represented groups
- Improving small businesses' experience of government services
- Developing better regulation and policy

Each of the themes has a solid base of evidence to support it, and a description of clear actions that need to be taken, primarily by government, to support those themes.

3.2. Application to Medium organisations

Although the plan describes itself as an action plan for small business, it applies to medium business as well, due to the remit of the Small Business Service which covers small and medium-sized businesses.

It is this additional coverage of medium organisations which makes the action plan central to the policy issues that impact medium organisations in the UK.

However, it must be said that medium organisations were not central to the action plan in its conception. The name itself (Action Plan for Small Business) is a giveaway that medium business was not the key issue analysed in the plan.

Secondly, and more substantively, there are a number of issues to do with the interaction of the themes with medium organisations that are simply not picked up in the report.

Here are some examples of these interactions:

- a) While there is plenty of discussion of the proportions of people going into business from different segments of society and the need for a more dynamic start-up environment, there is no analysis of the need for **entrepreneurial and innovative actions in existing businesses**, particularly within businesses that have scale and can make a larger impact on the economy, such as medium enterprises.
- b) Vigorous small business growth is essential for the economy but it is interesting to note that, according to SBS data, **medium organisations have greater intentions to grow**: 19% of M businesses plan to grow significantly, while 57% plan moderate growth, compared to 10% and 48% respectively for the entire SME sector, including M organisations.²
- c) Although a number of M organisations list access to finance as a key challenge impacting their growth prospects, the action plan features no analysis or actions aimed at dealing with **financing growth** in medium organisations.
- d) Regulation costs medium organisations more than it does small businesses. The average annual cost of implementing new legislation in a medium business is £15,327, compared to £6,444 in a small company, according to the Enterprise 2005 survey of the ICAEW.

3.3. Policy stance

This document is not claiming that the needs and challenges of small businesses are not important. Instead, it seeks to apply a new focus on the challenges facing those who lead medium organisations in the hope that it will engender a more rounded view of the issues involved.

Neither is it seeking to create an environment for justifying government interventions on behalf of medium organisations. Governmental intervention is not desirable in the marketplace, except in those conditions where the market mechanism is either weak or operating inappropriately. In some instances, different market failures compound each other's actions to create "inappropriate" equilibrium solutions. Some of these exceptional circumstances are listed below:

- Where there is imperfect or asymmetric information among market players
- Where it is difficult to defend intellectual or other property rights
- Where market structures are imperfect, as in the case of monopolies
- Where regulatory actions are either poor, ill-conceived or missing

It might be argued that the challenges of medium enterprise are not that important in the context of the UK economy, which could be why they have been ignored in the Action Plan for Small Business. Another argument could be that there is very little difference between small and medium enterprises. Neither of these arguments is convincing.

In fact, the foundation of the next chapter is built on the evidence that medium organisations are very different in their actions and behaviour relative to small businesses, and that M organisations have a substantial contribution to the economic performance of the country as a whole.

4. Defining and understanding medium organisations

Medium enterprises are nearly invisible in the UK. They have no profile in the market, government does not pay them any attention, and they are usually lumped together with small and micro enterprises via the SME label, although they are significantly different from those companies in almost all respects.

But what is a medium enterprise anyway? This section of the report looks at various definitions that have been applied to medium-sized organisations, and then uses the definitions to characterise the way these organisations behave.

4.1. Size definitions

The commonest definitions of medium organisations have to do with numerical boundaries. The measure used in UK government circles is based on employment with a small business defined as up to 49 people, and a medium business as up to 249, though account is also taken of annual turnover and asset values.³

As many European countries offered legislative and fiscal advantages to SME organisations, the European Commission offered a definition which has applied since January 2005 and is summarised in the table below:

Enterprise category	Headcount	Turnover	or	Balance sheet total
Medium	50 - 249	€ 10 - 50 million		<€ 43 million
Small	10 – 49	€ 2 – 10 million		<€ 10 million
Micro	<10	<€ 2 million		<€ 2 million

Table 2: SME definition adopted by the European Commission, January 2005

Many commercial organisations create their own definitions that fit their particular perspective. Software provider Microsoft, for example, classifies medium organisations as those that have between 50 to a 1000 PCs.

4.2. Size problems

While numerical boundaries simplify statistical analysis, they are not good at capturing reality.

For example, different industries have rather opposing views as to whether, say, a 50 man company is a small one or a medium sized one. Further, modern ways of doing business, like outsourcing, can change the employment numbers in a firm without changing the scale or “weight” of the organisation. Also, the internet has introduced business mechanisms which enable small organisations to scale across global markets.

Another problem with numerical definitions is that they need to be refreshed, as the metrics can get obsolete. After all, the European Commission definition of 2005 was really an update of a definition it put forward in 1997.

This is reflected in a pilot study of middle market firms conducted by the ESRC Centre for Business Research for the Department of Trade and Industry which defines small firms as employing 10-99 employees, and medium firms as employing 100-499 staff.⁴

No wonder, then, that a paper from Durham Business School describes medium enterprises as “*too Big to be Small and too Small to be Big.*”⁵

4.3. Differentiating medium enterprise from others

While a number of studies have been conducted on the shape and behavioural characteristics of medium businesses, three in particular stand out.

The Middle Market Model was studied by the Foundation for Small and Medium Enterprise Development (FSMED) at the University of Durham. It found that companies can be divided into three segments: owner managed, owner directed and global. Owner directed companies account for 25% of the economy, value added is growing at 8% per annum, and return on capital employed (ROCE) is at 9%.⁶

FSMED also found that there was a good match with the findings of the Centre for Business Research’s 2003 report which showed that certain behavioural characteristics demonstrated by the companies align themselves with the performance of the owner-directed companies. In particular, these were control by a CEO, customer diversification, corporate governance and professional management.

In 2005, research from the Institute of Chartered Accountants in England and Wales (ICAEW) and accountant BDO Stoy Hayward found that the real differentiator between small and medium enterprise is not scale, but frame of mind.⁷ Success in medium enterprise is driven by a distinctive blend of professionalism and an enabling culture in the service of long-term growth. The research found seven characteristics that set medium organisations apart from small ones.

M Institute is of the view that differentiation on the basis of business characteristics is superior to differentiation based on numerical definitions. As a result, this report extends the ideas in the 2005 ICAEW report to contrast medium enterprise with small and large organisations in nine different areas. Interestingly, in many ways, medium business is rather more like large business in its behaviour and characteristics, which makes it even more incongruous that medium business is compartmentalised with small business via the SME definition.⁸

Small business	Medium business	Large business
Owner-managed	Owners plus professionals in key leadership roles	Professional management
Micro-management of employees	Empowerment of employees	Freedom to act within corporate guidelines
Informal processes	Formal processes	Formal structures and processes
Short-term horizon	Longer-term planning horizon	Short-term results horizon / long-term planning horizon
Low external input	External input from professionals	Governance structure separate from management
Equity held by founder / family	Wider equity base	Diversified equity base
Small customer base	Diversified customer base	Diversified markets with diversified customers
Limited personnel development opportunities	Culture enables employee development	Multiple career development paths
Low borrowing requirement – government support possible	Borrowing needed long-term / funding available shorter term	Wide pool of funding sources

Table 3: Behavioural differences by size of organisation, M Institute, 2006

4.4. Contributions from Medium Enterprise

Regardless of which definitions are used to analyse the UK landscape for SMEs, we find that medium enterprises account for a substantial chunk of the performance of the UK economy.

Employee numbers

Using a more contemporary size definition of medium enterprise used by the SBS in 2004 covering organisations with between 50 and 500 employees, SBS data shows that this segment of the economy represents just under three-quarters of one percent of all enterprises in the UK but employs nearly 15% of the workforce, and contributes over 21% of annual turnover.

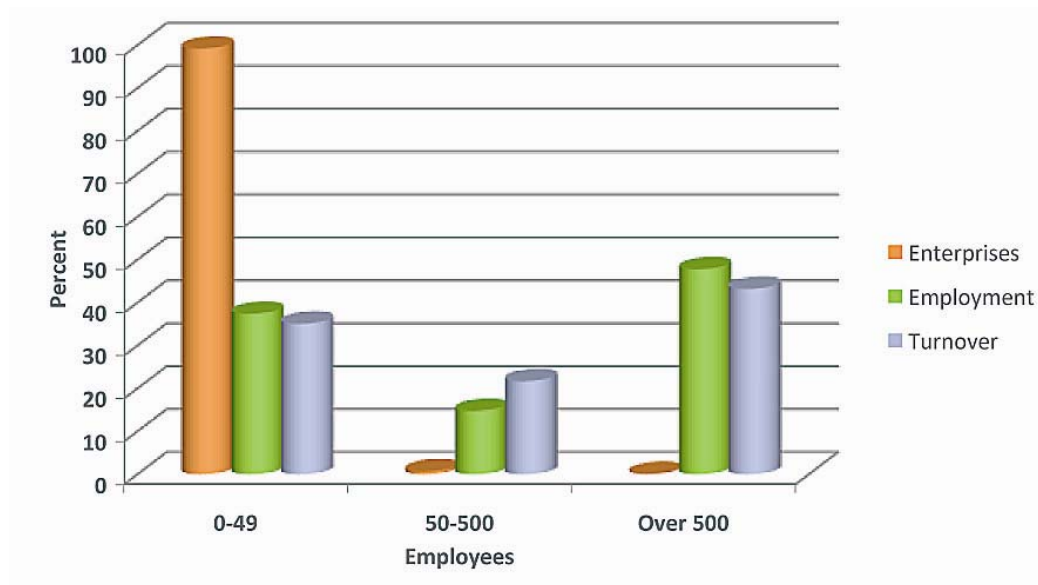


Table 4: Shares of economic performance, by size of enterprise, SBS data, 2004

Size of turnover

What the SBS data excludes quite deliberately from its remit are any companies that may be small or medium sized on their own, but which belong to any grouping of larger companies, for example, subsidiaries of larger enterprises.

The 2005 ICAEW / BDO Stoy Hayward study sought to take some of these into account as the challenges facing medium organisations in this category are often shared by other medium organisations, particularly when it comes to growth plans, ability to recruit key staff, raising finance, and dealing with regulation.

As a result, the 2005 ICAEW / BDO Stoy Hayward study finds that 6% of UK companies have annual revenues between £10m and £250 m, and employ 30% of the nation's workforce, and nearly 20% of all corporate profits.

This data indicates that medium organisations have a significant contribution to the economic performance of the country as a whole. However, the issues and challenges they face are different from those faced by small and large organisations. In the next chapter, we explore the comparative performance of small, medium and large organisations.

5. Comparative performance of medium enterprise

For the purposes of this report, a special analysis of the ICAEW's 2005 Enterprise survey⁹ was conducted to determine the performance of medium businesses relative to small and large companies.

5.1. Sampling the population

The Enterprise Survey is an annual survey conducted by the ICAEW among its members. In 2005, there were responses from 1214 chartered accountants working in business.

For this report, all companies have been analysed according to the size of their annual turnover. Those with an annual turnover of less than £5.7m have been categorised as 'small' businesses. Those with a turnover of £5.7m - £99.9m have been categorized as 'medium-sized' companies, whilst any with a turnover in excess of £99.9m have been categorised as 'large'. In total there were 480 responses from small companies, 508 from medium-sized companies, and 212 from large companies.

Given the focus of this report on medium-sized enterprises, such businesses have also been examined within two further categories. Smaller medium-sized businesses with a turnover of £5.7m - £22.8m have been classed as 'medium I' businesses whilst those with a turnover of £22.9m - £99.9m have been categorised as 'medium II'. There were 308 medium I companies in the sample compared to 200 medium II businesses.

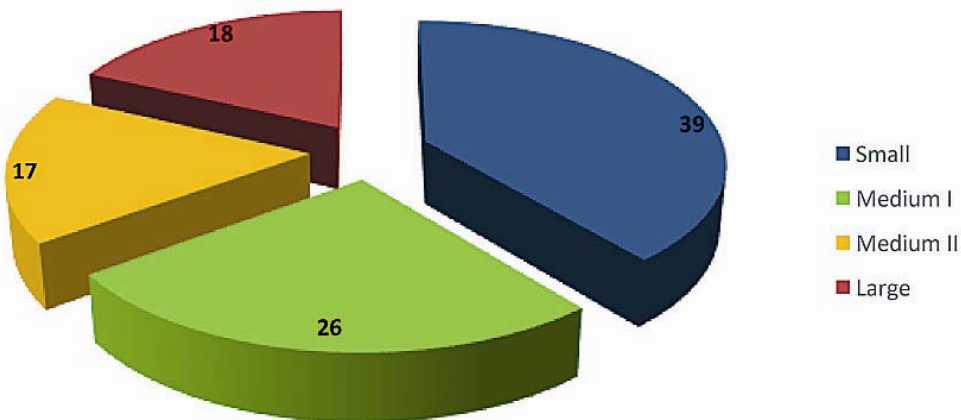


Figure 1: Companies by size in ICAEW Enterprise Survey, 2005

5.2. Growth comparisons, by size

Medium organisations are different from small and large organisations in their corporate expectations regarding growth and growth strategies– the following facts drawn from the Enterprise 2005 survey demonstrate some of those differences.

UK companies bullish about growth

The majority of businesses (75%) have grown over the past two years. Overall, differences by size of firm are not great, with 71% of small firms having grown at all over the last 2 years compared with 76% of all medium sized firms and 78% of the largest firms. Medium II businesses were the

most likely to have grown at all (80%), although in all but one case (medium II growth cf. growth of small business) this was not significantly higher. (see Figure 2).

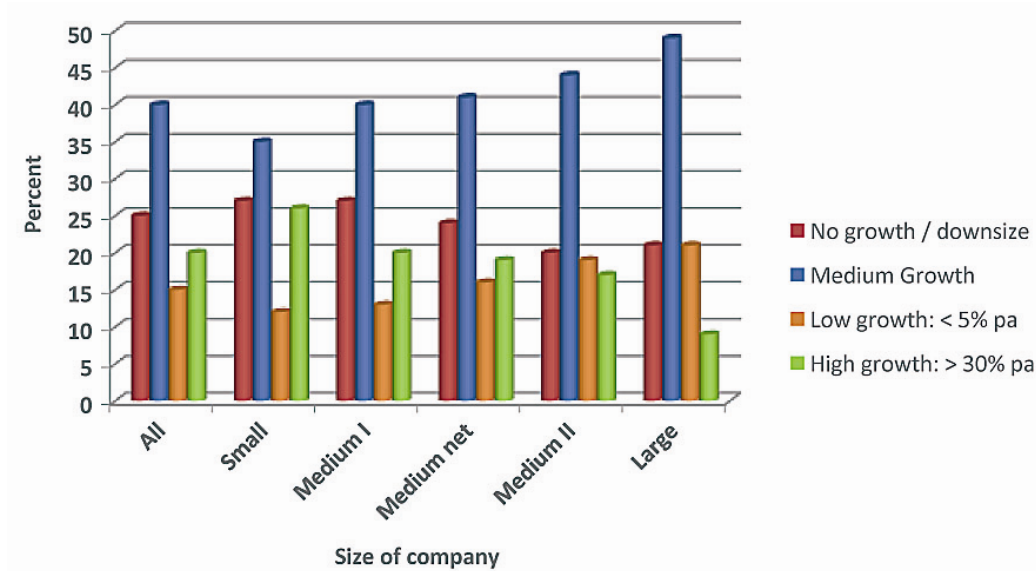


Figure 2: Past growth performance over two years, analysed by company size

69% of those companies in the 2005 survey were planning to grow by 6% or more per annum, including 16% planning to grow in excess of 30% per annum, classified as High Growth Businesses (HGBs).

- Medium-sized businesses were significantly more likely to be HGBs, than their larger counterparts (12% versus 6%). Medium I and medium II businesses were equally likely (12% and 13%) to have been HGBs, although smaller businesses were the most likely to fall into this category (23%)
- The majority of medium-sized businesses expect moderate growth in the next two years. Just over a quarter (27%) expect to grow by 6-10%, a fifth (19%) expect to grow by 3-5% whilst one in seven (14%) expect to grow by 11-15%

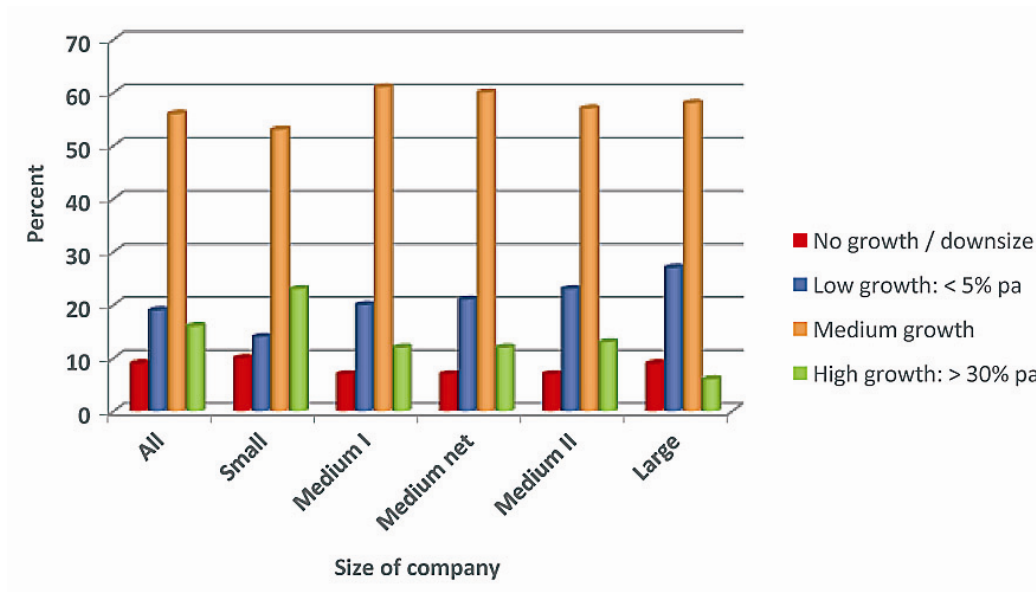


Figure 3: Growth prospects, analysed by company size

Strategies for growth

Improved sales (66%), marketing (47%), and the launch of new products (48%) are seen as they key drivers to growth across surveyed companies of all sizes.

- Of those companies that did achieve growth in the past two years, medium-sized companies are slightly more likely than both small and large companies to have done so through improving their sales and widening their customer base; 64% had grown through the use of this strategy compared to 58% of small companies and 51% of large companies.
- In order to grow the business, smaller companies were more likely than medium-sized companies to have focused on marketing (42% cf. 33%) whilst large companies were more likely than medium-sized companies to have restructured in order to improve their efficiency (42% cf. 30%)
- Medium II companies planning to grow over the next two years are most likely to be focusing on expanding their customer base and improving sales (76% intend to do so compared to 61% of large companies, 64% of small companies and 68% of medium I companies). Medium I companies on the other hand are the most likely to be intending to develop new products or ventures (55% intend to do so compared to an average of 48%)
- Medium-sized companies are more likely than both large and small counterparts to be planning on improving their products or production facilities (36% compared to 25% of small businesses and 31% of large companies). As was the case with past growth, medium II and large businesses are planning on being less reliant on improving their marketing (38% amongst both groups plan to do so compared to 55% of small companies and 47% of medium I companies)

As can be seen from the figures, medium businesses are different from small and large organisations. If they resemble another cohort, it is likelier to be large organisations, rather than small ones. To merge small and medium enterprises into a single category, such as SME, is inappropriate. The next chapter of this report explores the main challenges facing medium organisations which could be addressed by policy actions.

6. Challenges faced by medium enterprise

Medium enterprises are found in all sectors of the economy and share the specific problems with their peers in their industry. However, some of their challenges are common across the economy, and are attributable to the scale and sophistication of their operation. These issues are particularly important to keep track of in any discussion regarding medium enterprise.

6.1. Key challenges

The key challenges facing business leaders of such enterprises are:

Finding and developing executive talent to match changing business processes, and to build competitive organisational structures appropriate to those processes. 88% of medium businesses believe that their success is contingent on the quality of the leadership / management, in the context of which it is interesting that the development of both staff and management is seen to be the single most important success factor for a medium organisation.

Understanding growth strategies, particularly in the context of regional leadership and diversification of the customer base. Medium organisations have the same significance at regional level as the largest 300 organisations have on a national scale. Also, 46% of medium organisations have less than a fifth of their annual turnover from their top five customers, compared with 23% for small businesses. Many medium business leaders feel that growth is their key challenge – if they are not growing, they are probably slipping backwards.

Employing suitable financing strategies and instruments to facilitate diversification of the owner base and to enable the attainment of the organisation's chosen growth strategy. While there are more funding options open to medium enterprise than there are to small business, there are certain circumstances where medium enterprise finds that funding opportunities are very limited.

Exploiting technologies, innovation and intellectual property that support and enhance the working of a modern business. Most medium enterprises recognise that technology and innovation play a key role in two ways. The first important issue is managing diverse technologies in the interactions with customers, suppliers and partners. Secondly, it is the introduction of new innovations in products and processes that enable an organisation to derive competitive advantage.

Getting relevant outside professional help in areas covering innovation, brand management, market research, creative input, growth strategy, process management, tax and non-executive input.

Regulatory compliance – this area is possibly hardest for medium enterprise, compared to the other size cohorts, though the received wisdom is that it is small businesses that bear the burden of regulation. Small businesses either fail to meet red-tape thresholds or use outside services from accountants, etc to provide coverage in regulatory areas; large businesses usually employ professionals to cover every regulatory area themselves; medium businesses struggle to cope with the burden of regulation and compliance, as they usually cross every threshold, and have to deal with these issues themselves.

Globalisation is changing the dynamics of competition within national economies and across the globe. This is a relatively new area for leaders of medium enterprise to deal with. There are three related issues that they report. First, a number of medium enterprises are already global leaders in the niche that they operate in – these organisations worry about the changing economics in their market as a result of new entrants from competitive low-cost economies. Second, many medium enterprises which had no opportunity to play on a global stage can now do so, by the use of

technology and innovative processes to integrate into global supply chains and logistics operations. Third, medium enterprises face being outsourced out of their current customers who seek lower costs and newer technologies from overseas providers.

6.2. Policy issues relating to medium enterprise

The previous section of the report describes a number of challenges that medium enterprises face that affect their economic performance. However, just because these challenges exist does not mean that there need to be policy actions to address them. In fact, there is no expectation, or hope, on the part of leaders of medium businesses that they should be recipients of government help. On the contrary, only 7% of the leaders of medium enterprises believe that public help is actually helpful to them.

However, the challenges listed above are brought into sharp focus in certain areas where the market or regulatory mechanisms either fail, or are constrained in their action. In these situations, it seems valid to seek to address the causes of market or regulatory failure.

In this report, we identify four key areas where the judicious use of policy actions would benefit the working of the economy, without compromising any commitment to the use of market mechanisms.

These four areas cut across the seven key challenges facing business leaders in this segment, with the expected consequence of inaction usually causing problems in the area of growth. This makes them particularly important to address.

6.3. Challenge I: Access to capital

Growth needs money, and money looks for growth. But the two often don't find each other in the medium segment of the market.

A major factor affecting growth in medium organisations is access to capital. Growing a business needs capital. Not every medium organisation has difficulty in raising capital, particularly when the capital is needed for buildings and capital equipment. But capital is difficult to obtain when the driver for finance is growth or innovation which is not tied to capital expenditure. It is even more difficult when the track record of the organisation does not demonstrate a steep upward year-on-year growth curve. Yet it is these organisations that are delivering the most consistent growth performance in the UK economy.

Why is it hard to raise such growth finance? According to respondents to this research study, there are a number of reasons why.

One, UK banks appear to have a short-term view on lending which does not support the longer-term growth finance requirements of medium business. They are also risk-averse at the levels of finance sought by medium business.

UK banks seem to have a shorter horizon than European banks in this regard. The former measure their performance on transactions – the more, the better. They reward their staff, and make more money, if they can make two five year loans, than one ten year loan. The fact that the second loan is simply taken to finance the repayment of the first loan is ignored.

Two, private equity providers are perceived to have moved up-market so that their need for a return is such that companies have either to deliver a spectacular growth performance or give the investors a higher share of the business than they would like to. This is self-defeating for medium enterprise leaders who expect to be working to benefit themselves rather than somebody else. Business angels operate at a level of finance that is usually too low for medium organisations.

Three, there is a problem of imperfect knowledge that exacerbates the two previous points. While the credit rating for most large organisations is public knowledge, the credit rating of most medium organisations is completely unknown. Without undertaking extensive (i.e. expensive) due diligence, it is impossible to tell the difference between a fantastic prospect and a complete dud.

Policy actions

Government schemes for finance are currently aimed at start-up businesses and are irrelevant to medium business. In any case, very few medium organisations would expect, or even want, government funding.

What is needed is not funding, but ensuring that market conditions operate appropriately. In this regard, there are certain actions that can help remove the barriers that currently exist:

- Investigate why the longer-term financing model between banks and companies that exists on the Continent is not applied by UK banks
- Create a credit rating scheme for medium organisations. Currently, there are six major credit agencies that dominate the large enterprise segment of the market but with none playing in the medium business sector: clearly, there is an issue of scale involved. It may not be worthwhile for any one of the existing commercial credit rating agencies to push-start a scheme for medium organisations, but government could help remove the imperfect knowledge that currently exists between lenders / investors and borrowers.
- Investigate whether there is need in the UK for a funding agency that supports bank loans and other financing when the main use for the funding is to be innovative or enter new markets.

Getting credit ratings or having new loan support schemes will not solve growth and finance challenges among medium organisations. They will not even take away the need for due diligence on the part of the financier. But having a credit rating could mean that the conversation could happen at all. Having a support mechanism for innovation funding could mean that the conversation starts.

6.4. Challenge II: Regional development

The economic performance of medium organisations is as strong in a regional context as the largest companies are in a national context. As a result, the engagement of a medium enterprise with the growth drivers in a region is particularly important. Yet, we find a very low connection between regional strategies and medium enterprise.

Why is regional performance important?

Around the world, certain regions are performing so spectacularly that the entire country seems to be glowing green with growth. Yet, in the same country, other regions lag behind.

China is a case in point. In China's coastal regions, such as Dalian, Beijing, Shanghai and Zhejiang, per capita income is around US \$5000 per year, a figure already surpassed by Guangzhou. But in the hinterland, incomes fall away to between \$2000 and \$1000, and lower. If we treat regions as countries, then nine of the top fifteen Asian countries are actually Chinese regions.¹⁰

It is the strength of the regional economy which is the underlying reason why the World Competitiveness Centre at IMD now includes 8 regional economies, such as Zhejiang, Maharashtra and Sao Paulo, in its benchmarking of 61 countries for competitiveness.¹¹

The power in competitiveness studies comes from understanding what makes each region perform. In Zhejiang it is the clustering of electronic components supply chain participants and PC makers. In southern India, it is IT services. In Ireland, it is customer relationship management. The fuel for growth is often inward investment into these regions, and (unsurprisingly) the money

follows expertise and execution capability. While the inward investment is often done by large companies, the companies that benefit from such investment are the local medium-sized organisations that provide the skills, resources and energy to deliver on the demands of the companies making the inward investments. This issue also has cross-cutting significance on globalisation, inward investment and innovation.

It is in this context that the role of regional authorities is so important.

Regional authorities have to learn to be distinctive - they cannot be jacks-of-all-trades. This does not mean that every company wanting to succeed in Guangzhou needs to be an electronic component manufacturer. But it helps to have a strategy in components that companies in the region can fit their offerings into.

So what are the distinctives on offer from Britain's regional authorities, the RDAs? After all, these strategies can be really beneficial for Britain's mid-sized organisations to plug into, if they want to build their own growth strategies around the inward investment these strategies attract.

Here's the problem. How can you plug into a regional strategy from an RDA you have never come across?

This study found that only 14% of all businesses had any knowledge of the function of RDAs. This figure does not vary across size of business. What is likely to vary by size of organisation is the issues that they believe RDAs should be involved with.

	Overall	Small	Medium I	Medium II	Medium total	Large
Creating / safeguarding employment opportunities	14	14	15	16	16	14
Education and skills	14	13	16	17	16	13
Attracting / stimulating new business	14	14	11	18	14	13
Regenerating brownfield sites	6	6	6	6	6	6
Investing in deprived areas	4	4	5	5	5	3

Table 5: Desired priorities for RDAs, analysed by size: all figures are percentages

From the data, it is apparent that Medium II organisations are more interested in their RDA stimulating new business in a region, while Medium I organisations cite employment opportunities and skills development as their preferred priorities.

Policy actions

We don't need eye-candy brochures promoting a region's natural beauty. Unsurprisingly, inward investment into a region is never driven by what the region looks like. Instead, investors seek expertise and execution capability. Consequently, regional development will really work for medium organisations if:

- RDAs are intentionally strategic in choosing the strengths of the region they will focus on, in their efforts to attract inward investment
- As RDAs are relatively unknown among British companies, they need to make a conscious effort to promote their regional strategies to organisations *inside* their region so that the latter can plug into their region's competitive strategies.

6.5. Challenge III: Burden of regulation

The burden of regulation shows itself in three ways.

One, business carries the burden of much of the interchange between government and its citizens, whether processing tax, tax credits, maternity pay or even alimony payments. This represents an *administrative cost* on businesses for the privilege of being employers.

Two, there is a separate regulatory burden that comes from meeting government policies that relate to public safety, correction of market failures or the promotion of a fair business environment. This is usually referred to as the *policy cost of regulation*.

Finally, there is a cost borne by business that relates to the policy cost – this is the *administrative cost of complying with policies* getting to know the policies, keeping records on policy issues, reporting on compliance, and costs relating to government inspection and enforcement.

Each of these costs represents separate strands of regulatory burden. Although it is important to understand the components of the burden of regulation, it is fair to state that, as far as business is concerned, all these costs are taken together when it considers the costs of regulation.

Regulatory costs

While there are no firm measures on the cost of regulation in the UK, estimates from the United States and the Netherlands suggests that the total cost of regulation is around 10-12% of GDP. On that basis, the Better Regulation Commission estimates that the cost of regulation was in the region of £100 billion per year in 2005, slightly more than the combined annual yield from VAT and fuel duty, and almost up to the level of the projected income tax yield for 2005/6.¹²

Clearly, the issue is not a small one.

For individual enterprises, regulatory costs have resulted in 86% of businesses increasing the resources needed for handling regulation over a three year period, according to a CBI/Grant Thornton report in 2004.¹³

If anything, the current perception is that the pace at which new regulation is being added is growing. This study finds that 69% of medium-sized businesses cited at least one issue where the regulatory burden had worsened, while only 24% could identify an issue where the regulatory burden had eased.

	Overall	Small	Medium I	Medium II	Medium NET	Large
	%					
No further legislation for a fixed period, say 3 years	31	32	32	29	31	28
Removal/reduction in specific aspects of existing legislation, for example, maternity/paternity rights or identification procedures for new entrants	26	26	28	25	27	26
Simplification of legislation regarding disciplinary procedures	22	20	23	25	23	22
Simplification of payroll aspects of employment law	16	16	14	19	16	19
Not stated	5	6	3	4	3	4
<i>Base:</i>	1,214	480	308	200	508	212

Table 6: Preferred option regarding employment legislation, analysed by size of business

Employment legislation is a key area of focus when it comes to reducing the burden of regulation. However, opinion is divided on the best means of improving employment legislation, and

company size was not the key driver of these differences. Respondents to the Enterprise 2005 study were offered four different options but no single option was selected by a majority of respondents. The most frequently preferred option, favoured by almost a third of businesses (31%), was a guarantee not to introduce any further legislation for a fixed period. Around a quarter (26%) expressed a desire for a reduction in current employment legislation and a further fifth (22%) expressed concerns regarding the ability to dismiss employees by favouring a simplification of the disciplinary procedure. There were no significant variations in response according to company size.

Differential impact

The Enterprise 2005 survey from the ICAEW found that the average annual cost of implementing new legislation per surveyed UK business was £13,464. For the purposes of this study, the figure was analysed by size of business. As could be expected, the burden of new legislation rises in correlation with company size. On average, large businesses spend £25,761 compared to £6,444 amongst small businesses, with medium-sized businesses falling broadly in the middle of this range (£15,327). There was little difference between the average spent by medium I and II firms (£13,852 versus. £17,564).

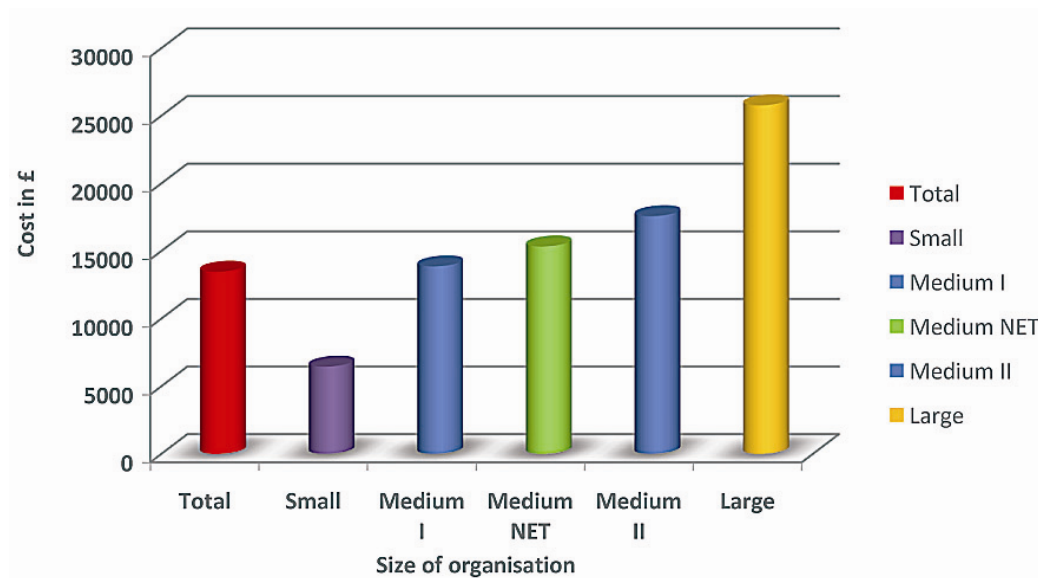


Figure 4: Estimated average UK cost of implementing new legislation, analysed by size of business

According to the Small Business Research Trust, businesses with over 50 employees need 43 hours per month to deal with **regulatory issues**, compared to 31 hours per month in organisations with 10-15 employees.

While the accepted wisdom is that regulation hurts small businesses the most, and this report does not seek to challenge that point of view, what is interesting to note in the SME context is that medium organisations face every single regulatory issue while small organisations face only a sub-set as they often do not meet the threshold of applicability. Also, small organisations are more likely to outsource their regulatory compliance to outside professionals such as accountants and payroll bureau providers who are better capable of handling those issues. Medium organisations tend to deal with regulatory issues themselves.

The challenge that leaders of medium business face is that the regulatory requirements they face are usually exactly the same as those faced by large businesses. There are certain industries where this situation is exacerbated by regulations relating to those industries. For example, medium

businesses in travel and financial services report additional regulatory issues they have to comply with, which come from watchdog bodies associated with their industry.

While nobody wants to see less protection for consumers, it may be appropriate in a B2B context for some of the risks that regulation seeks to contain to be handled instead by the companies that are trading with each other. After all, the finance director of a company should be a rather more informed and sophisticated purchaser of a company's goods and services than a consumer, and therefore should need less protection from regulation than the ordinary consumer.

Policy actions

We need to see three actions in the area of challenge relating to regulation:

- Steady performance by government in reducing the regulatory burden, on the lines of the Dutch model, where new regulation is considered only in the context of old regulations that can be scrapped.
- Simplification of the regulatory environment for medium organisations in particular, as they usually have to deal with regulatory issues on their own without the added infrastructure and manpower that larger organisation can use to deal with such issues.
- Reconsideration of the overall burden of regulation in those industries where there is additional regulation from an industry watchdog, such as in travel and financial services.

7. Further challenges in the business environment

The environment in which business operates is a mix of factors relating to the industry the organisation operates in, its own staff and resources, wider regional and national economic issues, and, increasingly, global challenges. Most of these issues have policy implications but in this section of the report, the focus is on two particular areas of the business environment, as these are areas that medium enterprise tells us is important to them, and where government can make a difference.

Although the main issues researched in this study covered access to finance, regional development and the burden of regulation, it was clear from discussions with leaders of medium organisations that there are a number of other issues that impact their performance.

Rather than ignore these issues on the basis that the research was not intended to cover them, this report has chosen to identify two factors that came up repeatedly in interviews: skills and transport. Clearly, both areas need more substantial research before policy recommendations may be identified. However, the issues are worth keeping in mind as ones that are particularly challenging for a number of leaders of medium organisations.

Skills

Key skills are important to growing businesses particularly technical, management and workforce skills. According to a DTI report¹⁴ on productivity and competitiveness, the lack of appropriate skills is complicit in holding back investment, innovation and productivity. In all these areas, the UK lags its G7 competition: for example, French productivity is 29% higher than the UK on an output per hour worked basis, while the US leads the UK by 27% on an output per worker basis.

Most growth businesses believe that shortage of skills is a hurdle for them. Some of the shortages are impacted by factors that go with the territory for M organisations: poaching, inability to hang on to top-class staff, lack of career progression paths, etc. Other factors causing shortages in skills are those that affect all companies to some extent or the other:

- Falling numbers of science and technology graduates – for example, only 3% of A level students in 2006 did physics compared to 9% in 1994
- Low proportion of workforce with intermediate education skills – for example, Britain lags the US, France and Germany in this regard
- High proportion of workforce with low-level skills – although Britain is level-pegging with France in this area, it has approximately double the proportion of lowly-skilled workers in the economy compared to the US and Germany.

This study found some UK-based medium businesses hiring from other EC countries on the basis that they believe continental graduates are better equipped to carry out their job than UK-trained graduates.

Transport

A major talking point for government has been its increased commitment to funding transport infrastructure, particularly in the context of public transport. These increases were highlighted by the Ten Year Transport Plan in 2000 and then revisited with further investment through to 2015 in *The Future of Transport: a network for 2030*,¹⁵ although some of the goals of the 2000 proposals had already fallen behind their targets by 2004. Some of the external assumptions in the plans are also not proving accurate, particularly the assumption that oil prices will fall steadily from 2000 to 2010, by which point \$16 per barrel was expected, a trend that has simply gone the opposite direction.

The transport network provides a key mechanism for the movement of people and goods in the country, and its performance is strongly influential on the success and competitiveness of British

organisations. As policy focuses on the public transport network (for good social, economic and environmental reasons), we cannot ignore the current configuration of land use in the country which is built on the presumption of point-to-point transport based on the car and lorry.

Medium organisations are more sensitive to the performance of the transport network than small organisations because they:

- tend to be strong regional performers, with presence across one or more regions
- usually have two or more locations that they operate from, often requiring transport to move goods and employees from one location to another
- recruit from a wider geographical pool, often having employees travelling across a region to go to work.

Unsurprisingly, leaders of medium organisations, particularly those from outside London, reported that transport problems, either due to delays on the road or lack of access to public transport, hold back their economic performance in a number of ways: making it harder to recruit people from outside a particular area, wasting time in transporting goods and people, and affecting growth opportunities when competing with countries that have superior performance in transport infrastructure.

In particular, with road use continuing to represent the largest percentage by far of passenger miles in the UK, it is important for policy-makers not to expect that large investments in public transport infrastructure will automatically result in a significant reduction in road use.

Further research

Much more quantitative work needs to be done in the areas of business environment to establish some clear foundations as the survey material this report is based on does not provide much insight on the impact of the business environment. However, our qualitative findings are that these issues are mentioned by leaders of medium business on a regular basis. So we have chosen to include the issues in the current report, and we hope to investigate the issues in greater detail in future.

ENDNOTES

¹ A Government Action Plan for Small Business, January 2004, www.sbs.gov.uk/action

² SBS Omnibus Survey, 2002

³ This definition derives from the 1985 Companies Act, which is also reflected in the European Commission definition of SME organisations, dating to May 2003.

⁴ Analysis of Middle Market Firms, ESRC Centre for Business Research, March 2004, www.cbr.cam.ac.uk/pdf/analysis-of-middle-market-firms.pdf

⁵ Snaith and Walker, The Theory of Medium Enterprise, Durham Business School, June 2002, www.m-institute.org/data/assets/pdf_file/344/Durham_TOME_Paper.pdf

⁶ The Foundation for Small and Medium Enterprise Development no longer exists as its place has been taken by two separate Enterprise Development programmes in Durham Business School. For more information on the Medium Enterprise Development programme, see www.dur.ac.uk/dbs/executive/enterprise_development.

⁷ Taking the M out of SME, ICAEW and BDO Stoy Hayward, June 2005, www.m-institute.org/data/assets/pdf_file/343/M_out_of_SME_paper_ICAEW.pdf

⁸ Any contrasts between organisations of different size obscure other differences or similarities that may occur due to ownership structures, type of industry, etc. For example, a large private company may have a longer-term results horizon than a medium-sized listed organisation.

⁹ For further information on the Enterprise Survey, as well as the ICAEW's SME policy agenda, please see www.icaew.co.uk/enterprise.

¹⁰ K Ohmae, The Next Global Stage, Wharton School Publishing, 2005

¹¹ IMD's World Competitiveness Centre studies data from 61 areas in the world, including 8 regions, with support from a network of 58 partners. More information on the study may be found at <http://www02.imd.ch/wcc>

¹² Regulation – Less is more, Better Regulation Task Force report, March 2005

¹³ CBI – Grant Thornton Mid Corporate Growth Survey, 2004

¹⁴ UK Productivity and Competitiveness Indicators 2006, Department of Trade and Industry, March 2006

¹⁵ The Future of Transport: A Network for 2030, Department for Transport, July 2004. The document is available at http://www.dft.gov.uk/stellent/groups/dft_about/documents/page/dft_about_031286.pdf.