UK FINANCE

Business Finance Review

UK Finance provides a regular analysis of how the finance needs of small and medium-sized enterprises (SMEs) are being supported through lending from mainstream lenders and specialised finance providers and also looks at their deposit holdings. This latest *Business Finance Review* provides a round-up of lending activity in Q3 2021. It shows how SME demand for new finance and repayment activity continued to evolve as the economy continued its recovery from the Covid-19 pandemic.

Stephen Pegge, Managing Director of Commercial Finance, comments:

“As the economic recovery continued in the third quarter, our finance indicators for SMEs have stabilised in recent quarters. Demand for new finance has been relatively subdued compared with that seen last year, as remaining restrictions have been lifted and businesses return to trading more normally.

“The focus for many businesses had now turned to meeting repayment obligations of government-backed loans accessed through the pandemic. Our data points to steady increases in repayments as they fall due, with growth in repayments evident across all sectors.

“However, many businesses will face some headwinds from supply chain bottlenecks and rising input costs. SMEs continue to have headroom within existing facilities, such as overdrafts and invoice finance lines, and high levels of cash deposits which should help meet these challenges. There is also flexibility in repayments through the Bounce Back Loan Scheme ‘Pay as you grow’ options.

“For businesses planning future investments the finance sector is ready to support these with commercial lending and the extended Recovery Loan Scheme, which will be available to SMEs into 2022. While the recovery will not be without growing pains, financial availability and support from the sector should help SMEs navigate these in the coming quarters.”

2021 Q3 HIGHLIGHTS

- **Gross lending to SMEs was £5.2 billion in Q3 2021, broadly unchanged from the previous quarter.**
- **Applications for new loans and overdrafts continued to trend down over the quarter – consistent across sectors and regions.**
- **IF/ABL advances increased by 11 per cent on the quarter.**
- **The value of repayments rose again in the three months to September, with a varied sector picture on the quarterly profile of repayments.**
- **Government-backed loans have shifted the balance between finance on fixed and variable interest rates.**
- **SME deposits rise further over the quarter with growth seen across all industry sectors.**
- **Overdraft utilisation remains below pre-pandemic levels, providing ongoing financial headroom.**

Company number: 10250295.
Registered address: UK Finance Limited, 1 Angel Court, London, EC2R 7HJ

Economic outlook

The UK economy recorded a second consecutive quarter of growth as recovery from the Covid-19 pandemic continued in the three months to September. With Covid-19-related restrictions largely lifted during the quarter, the final steps to fully reopen the economy helped to drive a 1.3 per cent quarter-on-quarter expansion of GDP. While this is solid by historic standards, it does represent a slowdown from the 5.5 per cent increase recorded in Q2 2021 and still leaves the economy some two per cent smaller than pre-pandemic levels.

Household spending, which was significantly curtailed during the pandemic, grew by two per cent compared with the previous quarter, making it again the main driver of growth. Much of this was spending on services, such as hotels, restaurants, and transport. Correspondingly, there was a strong performance in related sectors, with output in accommodation and food services, and arts and recreation posting a robust 30 per cent and 20 per cent increase in output respectively.

It was not a uniformly positive picture, with manufacturing and construction both recording declining output in the third quarter. This was signalled by a softening in survey indicators, such as the purchasing managers' indices, and reflects the widely reported disruptions to supply chains which have held back production in some industries, such as automotive.

There was a modest, positive contribution to growth from business investment in Q3, which grew by 0.4 per cent compared with the previous quarter. While the pick-up in investment was supported by spending on IT and other machinery, the level of business investment is still more than 12 per cent below where it was before the pandemic.

A further weak point in the third quarter data came from net trade, which dragged on growth. Export volumes declined on the quarter – driven by a fall in goods – while imports rose. Responses to the ONS Business Insights and Conditions Survey (BICS) indicates that Brexit- and Covid-19 related challenges for both exporters and importers persist. Businesses report that costs have increased and new frictions such as additional paperwork, customs procedures and border delays are impacting on international trade.

Despite some challenges to the recovery, the performance of the labour market continued to beat expectations. The most significant development over the quarter was the final closure of the government's Coronavirus Job Retention scheme at the end of September. Provisional data suggest that as the furlough scheme ended there were over 1.1 million people still on full or partial furlough, though this was 40 per cent lower than at the end of Q2. Survey evidence from ONS BICS points to a majority of furloughed workers returning to normal hours with their employer and limited signs of significant redundancies. This has subsequently been borne out in official labour market data, which showed a further fall in the unemployment rate in the three months to October to 4.3 per cent.

The number of vacancies also continues to rise, posting another record high in October. However, surveys suggest that businesses are also finding it more difficult than normal to recruit the right people. If there is a persistent skills mismatch between those exiting furlough and recruiting sectors, this would add some friction to the recovery in employment in the coming months.

The other notable development through the recovery is the strengthening inflation outlook. While many of the drivers of inflation, such as rising energy costs, were thought to be transitory, concerns have grown that higher inflation may be with us for longer and peak at around five per cent next spring. While higher inflation will squeeze real income growth for households, rising input costs are also being felt by businesses. Input costs for

manufacturers, for example, were up by more than 13 per cent in the year to October.

The inflation outlook is not just concerning for households and firms, it's also on the minds of policy makers. The Bank of England has signalled it is getting ready to raise Bank Rate from its emergency level of 0.1 per cent. A move had been expected by markets at the MPC's November meeting and while two members did vote for an immediate 15 basis point increase, the majority acknowledge that inflationary pressures were global in nature and preferred to wait for more clarity about post-furlough labour market developments. Nevertheless, a rise is coming, but recent Covid-19 developments mean the timing remains uncertain.

The other policy news on the quarter came from the Chancellor's Budget and Spending Review statement. While businesses have been supported through the pandemic with, for example the furlough scheme and government-backed finance, some additional support during the recovery came from business rates concessions and previously announced tax breaks for investment. However, many will be faced with a rise in employer NICS from next year.

The outlook for the UK economy can be characterised as fine rather than fantastic, but recent news of a new Covid-19 variant of concern brings uncertainty back to the fore. Before the new variant emerged, the Office for Budget Responsibility and the Bank of England, expected a return to pre-pandemic levels at the beginning of next year. Currently, forecasts show growth is expected to continue through 2022, but there have been some downward adjustments to growth projections. The boost from household spending will fade, with business investment and trade having to pick up the baton. While there are risks from inflation and ongoing supply chain disruptions, the more significant one at the time of writing is the impact of voluntary social distancing or other measures, in response to the new variant, which could again impact on demand and the ability of businesses to trade normally.

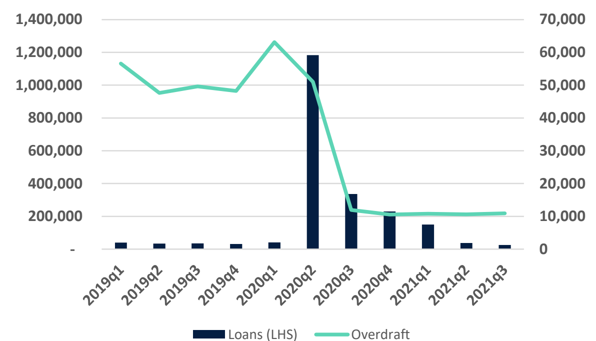
SME Finance

The business finance landscape has, inevitably, been heavily influenced, by the course of pandemic, and more significantly the finance support put in place jointly by government and the finance sector in 2020.

The availability of the new BBLS and CBILS products to support business survival led to a huge increase in demand for loan finance in Q2 last year, and our data shows that the volume of loan applications, which typically ran at around 150,000 per year in the years leading up to pandemic, increased more than tenfold last year.

There was some overhang of scheme lending into 2021 with applications for the original incarnations closing at end of March 2021, which means loan application volumes for 2021 as a whole are again on track to exceed those seen prior to the onset of Covid-19. However, the quarterly profile of demand has weakened markedly across the year, including in the most recent quarter covered by this Review.

Chart 1: Loan and overdraft application volumes



Source: UK Finance

Chart 1 shows the path of loan applications since 2019. In the three months to September loan applications dropped by a third compared with the previous quarter and follows a decline of three-quarters in Q2 following the end of the government loan schemes.

There are two factors likely underlying this trend – firstly, the requirement for finance through the pandemic and in the early stages of the recovery following the reopening of the economy has been satisfied in large part through government-backed loans.

Secondly, there remains an element of continuing caution about making significant investments until recovery becomes more firmly entrenched and headwinds from supply chain challenges and continuing questions over Brexit developments subside. However, analysis from ONS suggests that uncertainty as a reason to postpone investment is slowly diminishing.

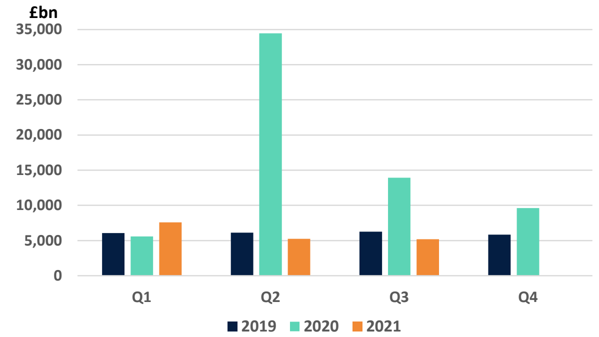
Demand for overdrafts over the period, also shown in ***chart 1***, has followed a rather different trajectory. Previous reviews have noted that firms substituted new overdraft facilities for term borrowing following the introduction BBLS and CBILS, but even following the end of the original schemes, overdraft applications have remained flat in recent quarters.

Comparing applications in the first three quarters of this year with the same period in 2019, volumes are around 80 per cent lower. Additionally, businesses with existing overdraft facilities are not utilising them as much as previously – we will return to this later.

The consequence of this softer demand for new finance in recent quarters was a very modest one per cent decline in overall gross lending over the quarter ***(chart 2)***. This points to a stabilisation of new lending to SMEs at levels close to those seen prior to the pandemic.

While not all lending applications in any quarter will translate into lending in that period due to, for example, processing time, the data does suggest that there has been an increase in the size of facilities approved. This could be a consequence of some restructuring of facilities among firms, acquisition activity or some parts of the SME community bucking the broader investment trend and expanding their business and taking advantage of the tax breaks currently on offer.

Chart 2: Gross lending to SMEs through loans and overdrafts

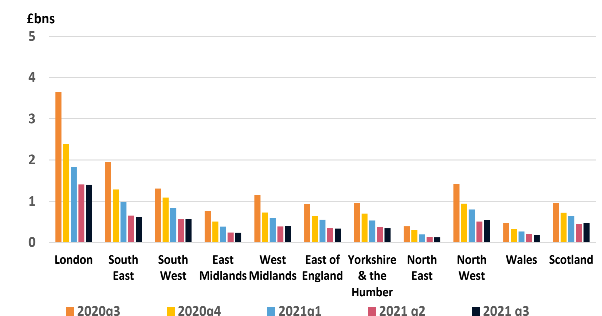


Source: UK Finance

Throughout the pandemic there has been a large degree of consistency in demand and lending patterns across sectors and regions, with trends across both indicators following the national picture over the past six quarters. We noted in the last BFR that lending though government schemes in sectors and regions had, by and large, followed the respective shares of the business population. Trends in the most recent three-month period have not deviated materially from this.

Chart 3 shows the regional distribution of gross lending. In every region lending is down compared with when government-backed schemes were live but have been broadly stable in the past two quarters. Falls in lending were slightly larger than the GB average in the North East and Yorkshire and Humberside, but conversely there was some modest growth in the North West, South West and Scotland.

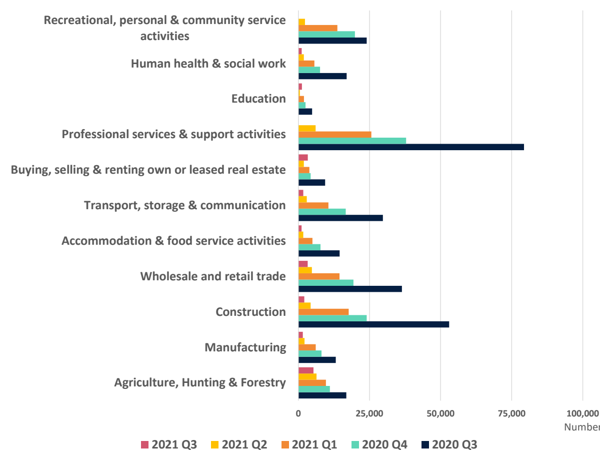
Chart 3: Gross lending by region



Source: UK Finance

Chart 4 considers sectoral trends. This metric is volumes of approved loan and overdrafts. In the three months to September the trend in approvals across all reported sectors is consistent with the decline in applications, nationally over the quarter as shown in ***Chart 1***.

Chart 4: Number of approved loans and overdraft by sector



Source: UK Finance

One area of finance which shows signs of bucking the trend reported so far is IF/ABL. In last quarter's review we noted that falling client numbers looked to be bottoming out, with some increases seen amongst larger businesses, a trend which continued in the most recent quarter's data. Total IF/ABL client numbers inched higher in Q3 compared with Q2 with growth concentrated amongst firms in higher turnover brackets (above £10 million). In addition, the number of clients in construction and transport have recovered to levels reported at the end of 2019. There is, however, still some way to go before pre-pandemic overall client numbers return.

Advances through IF/ABL facilities also continued to recover this quarter, increasing by 11 per cent compared with Q2 to £16.5 billion, this also represents a 28 per cent increase from the low point at the end of 2020 Q2. This rebound, compared with the start of the pandemic when businesses switched away from IF/ABL funding to government-supported loans, is seen across all firm sizes, except the very smallest (turnover of less than £0.5 million).

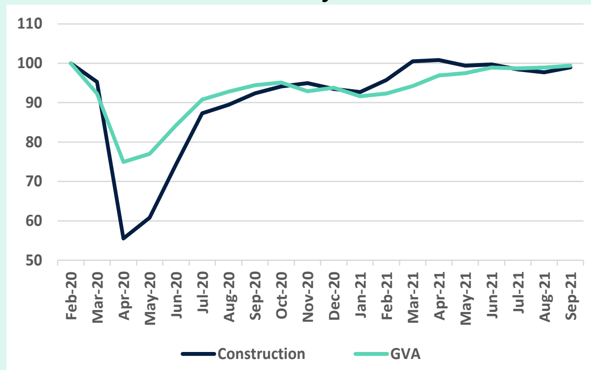
SPOTLIGHT: CONSTRUCTION

Each quarter the BFR focuses on the finance position of a particular region or sector. This quarter the spotlight is on construction. The industry's output has followed a similar path to that of the economy overall through the pandemic period.

*As **Chart 5** illustrates, output in the construction sector was halted abruptly with the first lockdown with sites closing in response to social distancing restrictions. In the first full month of restrictions (April 2020) output in the sector contracted by over 40 per cent compared with a 19 per cent decline in the economy as a whole.*

Activity rebounded in line with the end of the first lockdown and the sector was significantly less affected by subsequent periods of lockdown with activity continuing to grow through the first half of 2021. According to the IHS Markit/CIPS construction PMI, activity in the residential sector has been particularly resilient, with commercial and civil engineering catching up in the first half of this year.

Chart 5: GVA index February 2020=100



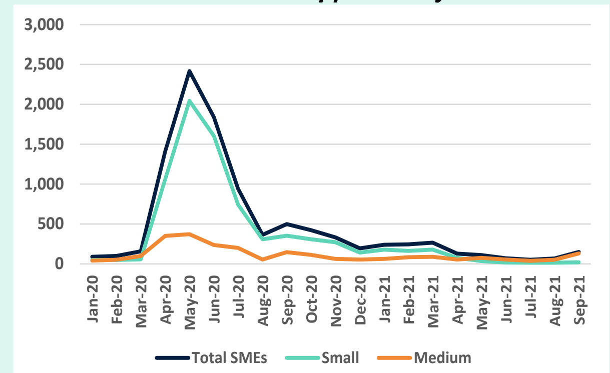
Source: ONS

There has, however, been some softening in survey and official data in more recent months. The ONS Q3 GDP release pointed to a 1.5 per cent fall in construction output in the three months to September. The sector has been at the sharp end of supply chain disruptions and rising input costs. While both the ONS data and PMI signal a robust demand environment, difficulties sourcing materials are affecting contract negotiations and activity on the ground. The effects of rising prices and some material shortages are being further compounded by recruitment challenges. The ONS BICS reported that more than a fifth of construction firms were experiencing a shortage of workers, the third highest of any reporting sector.

While there were more 'normal' levels of activity in the sector compared with, for example, contact-intensive services, construction firms have also accessed a range of government support on offer. At the peak over 700,000 employees in the sector were furloughed and businesses were borrowing through the government-loan schemes in line with construction's share of the business population. This equated to 276,500 CBILS and BBLS facilities of a value of almost £12 billion.

*Analysis of UK Finance data, shown in **Chart 6**, shows the rapid growth in the volume of loans approved to small and medium-sized construction businesses following the introduction of lockdown restrictions and the roll out of CBILS and BBLS. Small businesses (with a turnover of less than £1 million) and were the main driver of the growth in loan approval that occurred in Q2 2020.*

Chart 6: Number of loans approved by business size



Source: UK Finance

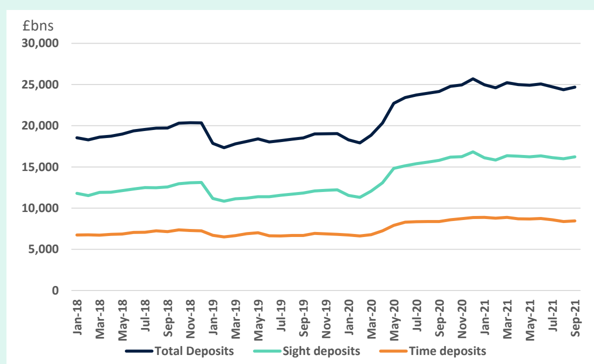
The peak month in May 2020 saw approvals running 50 times higher than average monthly approvals reported in 2019. Lending approvals to medium-sized businesses also increased rapidly, but to a significantly lesser degree. In

line with that seen across the economy, there has been a subsequent moderation in demand and in the most recent quarter approvals ended the period in line with that seen prior to the pandemic.

In contrast to the increase in demand for loans, which were the primary government-backed facility type, overdraft demand has followed the same path as that seen in the rest of the economy, dropping rapidly with the introduction as government schemes and remaining at levels below that seen in 2019, including in the most recent quarter. Overdraft utilisation rates in the construction sector currently stand at around 30 per cent, significantly below levels seen through 2019 and lower than the whole economy average, though lower utilisation rates in construction is typical. As noted above, advances through invoice finance and asset based lending have recovered more strongly.

Construction firms have also increased deposit holdings during the past 18 months ***(chart 7)****. Total deposits held by small businesses in the sector rose by 40 per cent between January 2020 and September 2021, with growth in medium-sized companies running not far behind at almost 30 per cent.*

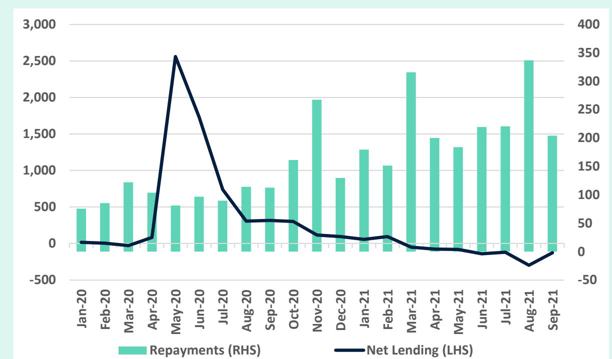
Chart 7: SME Deposits



Source: UK Finance

In recent quarters attention has turned to repayment activity as BBLS and CBILS taken out during the pandemic fall due for repayment. ***Chart 8*** *shows the monthly profile of repayments for the sector. Monthly repayments have seen a notable increase since March this year with some spikes in the value of repayments in March 2021, ahead of payments falling due and again in August this year. Overall, the value of repayments across the sector were over a quarter higher in Q3 compared with Q2, with medium-sized businesses disproportionately contributing to this growth. The ONS BICS points to relative high levels of confidence across construction firms that they will be able to meet debt obligations.*

Chart 8: Repayments and net lending

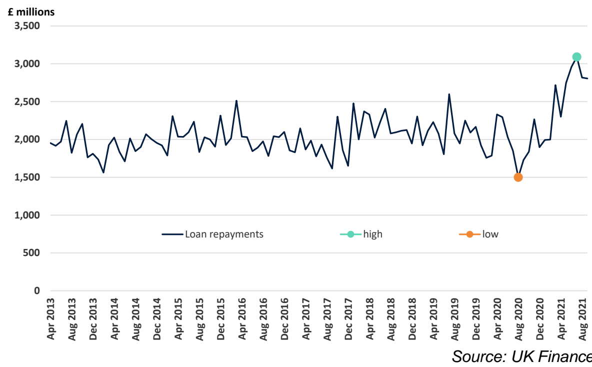


Source: UK Finance

The construction sector demonstrated resilience through the Covid-19 pandemic, but the reopening of the economy and emergent recovery has created some particular growing pains for the industry, namely from the widely reported disruption to supply chains, delivery and cost of key materials. The pace and extent to which these unwind through 2022 will be important determinants of its performance next year. A generally positive demand outlook and relatively high confidence about growth amongst construction businesses should translate into continued expansion in the coming years. Sector forecasts from NIESR indicate that after a robust 13.9 per cent growth this year, GVA in the sector should increase by over four per cent in 2022.

Repayments

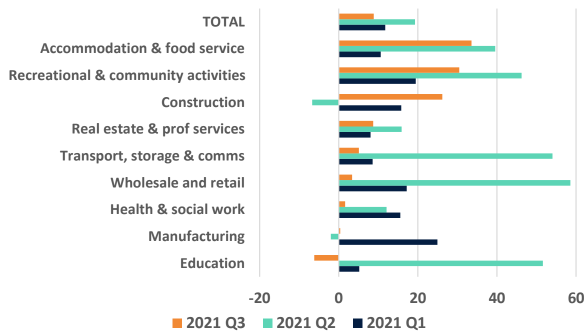
Chart 9: Repayments



Source: UK Finance

While demand for new finance remains relatively subdued, repayment of existing facilities continues apace as repayment of BBLS and CBLIS facilities continue to fall due and businesses meet their obligations. ***Chart 9*** shows continued growth in the value of repayments from SMEs in the three months to September, with a nine per cent rise compared with the previous quarter. This follows a 20 per cent surge in Q2, when many government-backed loans started to fall due for repayment. The peak in repayments, thus far, was in July, which perhaps coincides with the final steps of reopening activity in the economy and business confidence to pay down loans taken out during the pandemic.

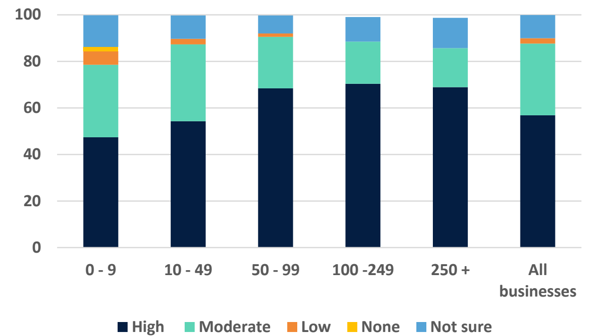
Chart 10: Change in repayments by sector



Source: UK Finance

Chart 10 shows some sector variation in the quarterly profile of repayment activity. Manufacturing, construction, and recreation and community activities saw a sharp increase in repayments compared with other sectors in the first quarter of the year. Most sectors reported significant growth in repayments in Q2, in line with the payment requirements of government-backed loans. In the most recent quarter, repayments from accommodation and food services have seen the strongest growth, likely a consequence of the schedule of restrictions being lifted and turnover starting to normalise.

Chart 11: Confidence in meeting debt obligations, by employee size



Source: ONS BICS

We remain in the early days of government-backed loan repayments. The term of BBLS is six years, though businesses have the option to extend beyond this with a 'Pay as you grow' term extension. Future developments in the economy could yet have a bearing on whether the pace of repayment growth we have seen in the last few quarters is sustained. Nevertheless, there is a reasonable level of confidence amongst businesses that they will be in a position to meet future debt obligations. But as ***Chart 11*** shows this confidence increase with business size. Just under half of businesses with fewer than ten employees report a high degree of confidence about their ability to service debt levels. This increases to seven in ten of the larger SMEs with between 100 and 250 employees. Perhaps encouragingly only around two percent of all businesses have low or no confidence about meeting repayment obligations.

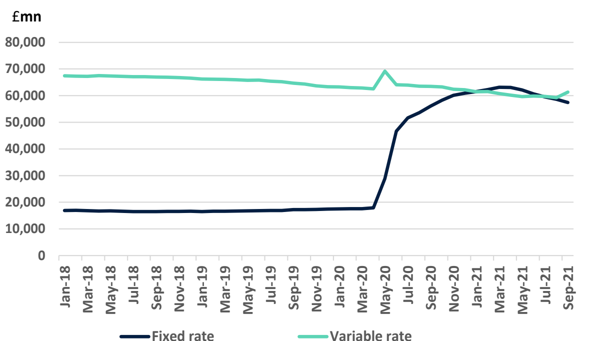
Unsurprisingly there is also variation across sectors, with 85 per cent of manufacturers reporting high or moderate confidence compared with six in ten businesses in the transport and storage sector.

Interest rate rises

As noted in the economic introduction, the prospect of a rise in Bank Rate is on the table. Much of the focus of how this will feed through to the economy focuses on mortgage holders (see our Q3 HFR). Here we take a look at how it might impact on businesses.

Chart 12 illustrates the shift in the balance from variable to fixed-rate loans for businesses. Historically, the majority of business lending was agreed on variable rates, but the significant volume of lending undertaken by the finance sector under government-backed schemes has driven a significant shift towards fixed-rate lending. BBLS loans have a fixed 2.5 per cent interest rate over the term of the loan, for instance.

Chart 12: Value of loan balances by interest rate type



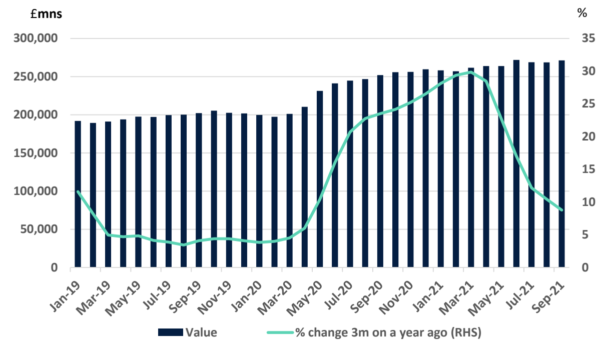
Source: UK Finance

Therefore, for many businesses, particularly smaller ones which may have borrowed for the first time under the government schemes, any imminent increase in Bank Rate will not impact on the servicing costs of the loan.

Financial headroom

With demand for lending stabilising and repayment activity edging higher, where does this leave the financial wiggle room available to SMEs? Starting with available cash, ***chart 14*** shows levels of deposits have stabilised over the quarter, though remain up on the same period a year ago.

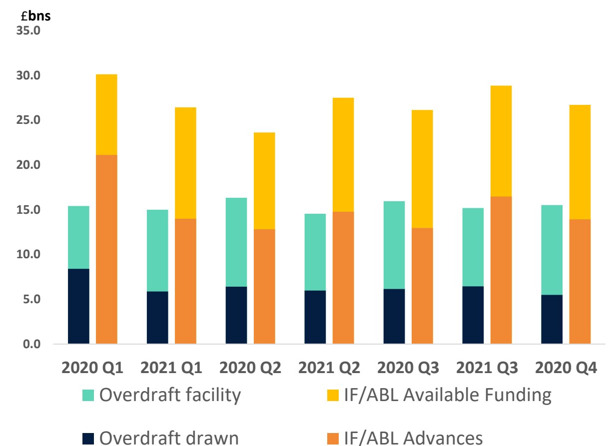
Chart 14: SME Deposits



Source: UK Finance

Like the other metrics discussed in this review, the change was consistent across most sectors, indicating that this is a continuation of an economy-wide trend. However, growth was somewhat stronger in accommodation and food services, which again is likely linked to the fuller reopening of the sector during this quarter and an associated recovery in revenues in businesses which had seen activity curtailed to a greater degree over the past year.

Chart 15: Overdraft and IF/ABL utilisation



Source: UK Finance

Note: Overdraft data relates to businesses with turnover less than £25m, IF/ABL includes all business

In addition to the flexibility a stronger cash position offers SMEs, overdraft utilisation rates remain below pre-pandemic levels, though they have inched higher over the quarter (***Chart 15***), with businesses becoming more likely to use existing facilities to meet restart and other operating costs.

Overdraft utilisation was 43 per cent in the third quarter, a shade higher than the 40 per cent in Q2.

Outlook for SME finance

There is a largely stable picture for business finance in the third quarter of 2021, continuing the trend of waning demand for new finance, an increasing focus on repayments with businesses retaining a reasonable degree of headroom with cash deposits, and flex in existing finance facilities. These headlines are, to a very large extent, replicated across all regions and sectors.

If the economic recovery is not derailed by recent pandemic developments, we might expect these to be consistent themes in our BFRs in the coming quarters. However, with some of the headwinds to growth, from supply chain blockages to rising input costs, falling more heavily on some sectors than others, we may begin to see the emergence of some sector differences in the financial position of the SME population.

A key question going into 2022 will be whether businesses will pick up the baton on growth by increasing their investment plans. Many SMEs have ready cash to do this, and depending on expansion ambition, the need to invest as part of a journey to net zero or the replacement of obsolete equipment to improve productivity, there is a range of finance products and providers to support this – including the recently announced extension of the Recovery Loan Scheme.

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