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 looks at their deposit holdings. This latest *Business Finance Review* provides a round-up of lending activity in Q4 and across 2020 as a whole. It shows how SME demand for finance developed through the unprecedented challenges and uncertainty resulting from the Covid-19 pandemic.

Stephen Pegge, Managing Director of Commercial Finance, comments:

"The enormous disruption faced by SMEs in the past year has been matched with a significant increase in the supply of finance, particularly that supported by government-backed schemes. Demand has, however, slowed from the peak in Q2 2020. Throughout the past year the more than doubling of gross lending will have been a vital lifeline in managing cashflow and sustaining activity through the successive lockdowns.

"With the four nations providing more detail of the route out of restrictions, uncertainty should start to ebb. But recovery will bring different challenges for many businesses as restart costs and the tapering of non-finance support brings new cashflow pressures which could stress particularly fragile sectors.

"SMEs have entered 2021 with some financial headroom in the form of increased deposits and flexibility in existing overdraft, invoice and asset-based lending facilities. Though concerns are likely to persist about the sufficiency of these in the face of ongoing uncertainty about recovery. The UK finance industry will continue to support businesses across the country to help them trade and invest for recovery."

2020 HIGHLIGHTS

- **Gross lending totalled £63.6 billion in 2020, some 162 per cent higher compared with 2019.**
- **Peaking in Q2 2020, gross lending fell in subsequent quarter to £9.6 billion in Q4, still 65 per cent higher than Q4 2019.**
- **New lending approvals in Q4 have dropped from their peak across all industry sectors and regions.**
- **Overdraft applications and approvals hit a series low in Q4.**
- **Overdraft utilisation has dropped back to 35 per cent.**
- **IF/ABL advances averaged £6.1 billion in 2020, down from £9.1 billion in 2019.**
- **SME deposits were up 28 per cent compared with the start of 2020 to stand at £259 billion.**

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Economic outlook

The UK economy recorded the biggest contraction on record in 2020 as much of the country was disrupted by a series of public health restrictions to manage the Covid-19 pandemic. GDP shrank by 9.9 per cent over the year as a whole, though the bulk of that contraction was experienced during the first economy-wide lockdown in the second quarter. While there were signs of recovery as some restrictions were tentatively lifted in the summer, an escalation in the spread of the virus and new strains meant this reopening and therefore economic recovery was short-lived. 2020 ended with a whimper, with the UK economy expanding by just one per cent. And ongoing restrictions, together with the introduction of new trading rules with the European Union, continued to depress activity at the start of 2021.

Few SMEs have been shielded from the economic fallout from the pandemic. The SME Finance Monitor in Q4 2020 reports that 73 per cent of SMEs have been negatively or very negatively affected by the pandemic, and as we have noted previously, consumer-facing sectors such as hospitality have been hardest hit. The same survey points to fragile confidence about the near-term outlook, with only a fifth of SMEs believing that the worst is now behind us.

Regular surveys from the ONS Business Impact of Coronavirus survey (BICS) show that over the course of last year more than two-fifths of SMEs have seen turnover below normal and around half have only low to moderate confidence about future survival. The scale of monetary and fiscal support provided in response to the crisis has, thus far, limited the number of business failures.

With the successful roll out of the vaccine in the UK and a roadmap for gradual reopening of the economy, forecasts point to a gradual strengthening in activity as we move into the second half of 2021. Consumer confidence has recovered from last year's lows, with households feeling less negative about the economic situation and their appetite for major purchases. There has also been a substantial build-up of savings in the economy, though this is asymmetric across different types of households. The global economic outlook has similarly improved, with a new US administration and significant stimulus package contributing to the stronger growth outlook.

Nevertheless, uncertainties remain. The unwinding of the various government support packages is expected to lead to a rise in unemployment and business failures are likely to pick up as cashflow pressures ramps up with the restart, putting fragile sectors and businesses most at risk.

Aside from the pandemic, there is the additional challenge for some international businesses of adapting to the new trading reality with the European Union. There was a sharp fall in exports reported by ONS at the start of 2021, but the full impact of the deal will only become clear over time.

Inevitably business investment has suffered over the past year and the future path is particularly uncertain, with cash constraints, an uncertain market outlook and the effects of Brexit still unfolding in 2021. However, significant tax incentives introduced in the Budget 2021 could reshape the profile of investment recovery or at least bring it forward.

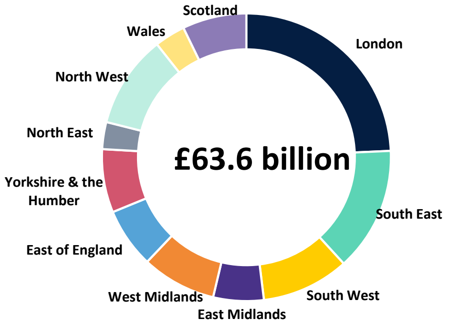
Forecasts from the National Institute of Economic and Social Research indicate growth of 3.4 per cent in 2021, picking up to 4.3 per cent in 2022. At a sector level, recovery is expected to be more robust in production industries, construction and finance and somewhat weaker in private sector services. Unemployment, which has been constrained to a large degree by the government's furlough support, is expected to gather pace later this year, peaking at 7.5 per cent by the end of the year. While government set out its plan to support the labour market and investment in the March Budget, monetary policy is also will also remain accommodative, with no change in rates this year.

SME Finance

The Covid-19 pandemic, associated public health restrictions and ensuing economic recession brought about a sea-change in the lending landscape for small- and medium-sized businesses in the UK. The sharp contraction in demand and enforced closure of businesses at various points in 2020 put huge pressure on SMEs' finances, and as noted in previous Business Finance Reviews (BFR), a range of interventions, including government-backed loans, were introduced to help firms manage cashflow, reduce outgoings and retain employees.

Government lending schemes, in particular, have expanded finance supply to SMEs across the UK during 2020. The latest Business Impact of Coronavirus Survey (BICS, wave 25) showed that a third of all businesses had accessed a government-backed loan or other finance agreement at some point during the pandemic. The latest data on gross lending also shows the scale of the demand for finance amongst SMEs. Across the year as a whole, gross lending totalled £63.6 billion (**chart 1**). This value of lending is more than two and a half times greater than that recorded in 2019 and marks the end of a period of relative stability in SME lending, when annual totals ranged between £21 billion to £26 billion for much of the preceding decade.

Chart 1: Gross lending to SMEs during 2020

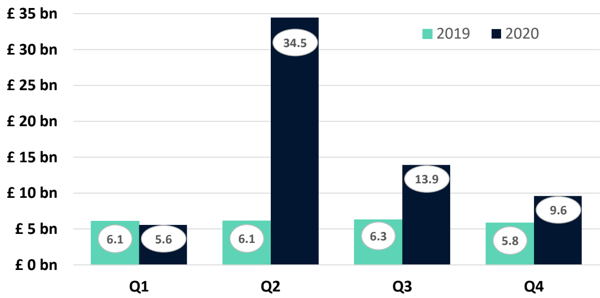


Source: UK Finance

As the BFR showed last quarter, the bulk of this lending took place in Q2 2020 – indeed we can now see that over half of gross lending over the full year took place in the three months to June 2020. This aligns with the onset of the pandemic and the roll out of government support schemes.

The latest data, shown in **chart 2,** shows that gross lending continued to trend down in the final months of last year. The amount of lending approved in the final quarter of last year was £9.6 billion, representing a 31 per cent fall compared with Q3 and a 72 per cent fall on Q2. Nevertheless, lending in the final three months of 2020 was still two-thirds higher than the same period in 2019.

Chart 2: Gross lending to SMEs through loans and overdrafts in 2020 compared to 2019

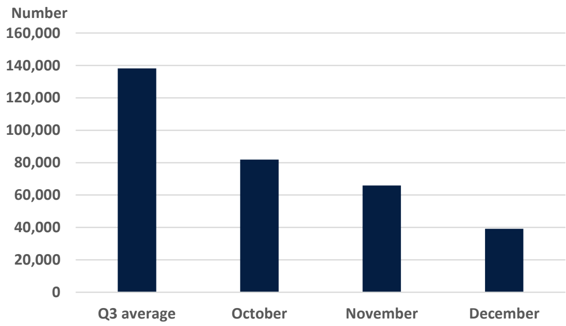


Source: UK Finance

We know that a substantial portion of total lending across last year was related to government schemes delivered through the banking sector. Data from HM Treasury showed that to mid-December 2020 some £63 billion had been lent under the Coronavirus Business Interruption Loan Scheme (CBILS) and Bounce Back Loan Scheme (BBLS). It is important to note that this total includes businesses of all sizes, including large ones.

The HM treasury data also points to a slowdown in new lending through government schemes (**chart 3**), which will underlie the broader reduction in gross lending across the SME population over the latter part of 2020.

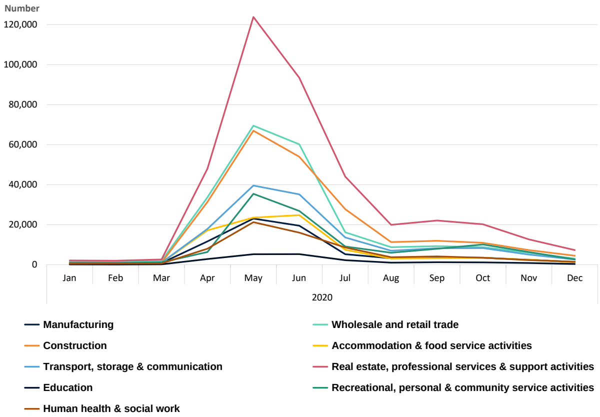
Chart 3: Number of monthly CBILS and BBLS approvals



Source: HM Treasury

As seen in previous quarters, the lending picture across different industry sectors has been fairly consistent, with all parts of the economy feeling the effects of the economic shock and making use of the government-backed financial support available. In Q2 there was a significant rise in lending across all sectors, though the hardest hit consumer-facing sectors such as accommodation & food services and wholesale and retail trades recorded a disproportionately large volume of CBILS and BBLS lending relative to their business share of the economy. Following the sharp increase in borrowing in Q2, there has subsequently been a largely uniform picture across sectors of moderation in new lending in the second half of last year (**chart 4).**

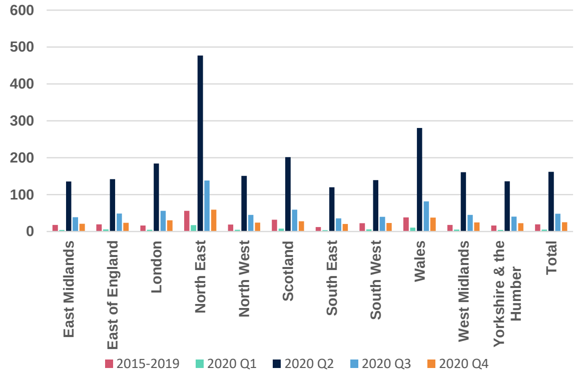
Chart 4: Number of SME loans and overdrafts approved by sector



Source: UK Finance

The regional picture of lending across the economy (**charts 5** and **6**) tracks the profile of national lending over time, with all regions recording a spike in the number of lending approvals in the second quarter of last year and a subsequent slowdown in the following quarters. Across most regions, the data points to a relatively even distribution of lending approvals relative to the size of the business population, though the North East and Wales are clearly outliers, with a significantly higher number of approvals per thousand businesses compared with elsewhere.

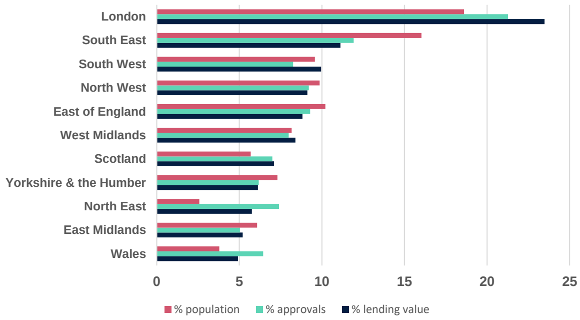
Chart 5: SME loans and overdrafts approved per thousand businesses by region



Source: UK Finance

Chart 6 shows that in the North East and Wales, higher approvals also translated into a higher share of total lending in these regions compared with the size of the business population. This was also the case in London, with 24 per cent of total lending going to SMEs in this region compared with London's 18 per cent share of the SME population. This is broadly in line with HM Treasury data on the regional distribution of government-backed schemes. However, it should be noted that **charts 5** and **6** also include non-scheme lending.

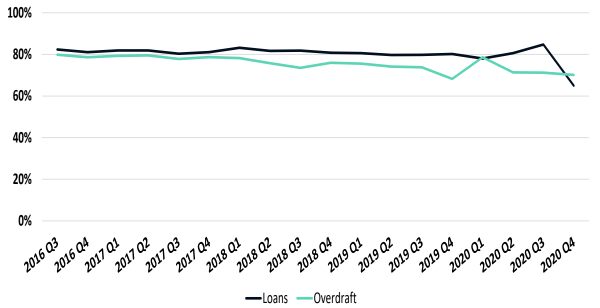
Chart 6: Share of the number and value of lending approved by region



Source: UK Finance and BEIS population estimates 2020

Throughout this incredibly uncertain period for SMEs, **chart 7** shows that approval rates on new loan applications were largely high and stable. During the peak lending quarters in 2020, approval rates continued to run at around eight in ten applications. However, this rate has dipped to around two-thirds of applications in the final quarter of 2020. This quarter-on-quarter decline reflects a monthly profile of applications and approvals that was considerably more volatile than usual, particularly amongst smaller businesses, over the quarter. Applications and approvals dipped in November, but the latter recovered to levels seen earlier in the year in December, indicating some short-term fluctuation rather than the start of a declining trend.

Chart 7: Borrowing approval rates for loan and overdraft applications

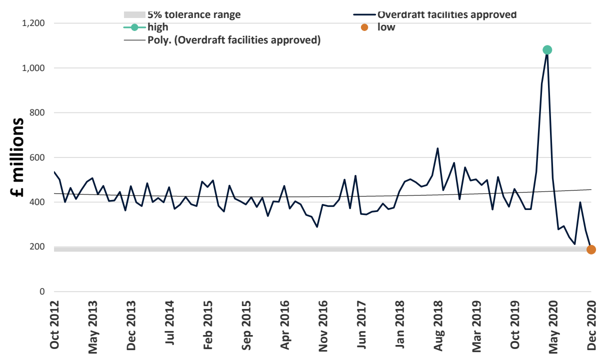


Source: UK Finance

While **chart 7** shows rather more stability in approval rates for overdrafts throughout 2020, overdrafts were something of a non-story last year. In contrast to the sharp rise in overall lending to SMEs in 2020, the profile of demand for overdraft facilities looks markedly different. As noted in previous BFRs, there was a sharp increase in overdraft applications at the start of 2020 – a likely precautionary measure as the full extent of pandemic had yet to unfold, thereafter SMEs were less focused on finance for day-to-day cashflow management and more on utilising the government-backed life-support measures already discussed.

In the final months of last year overdraft approvals stabilised at historic low levels (**chart 8**).

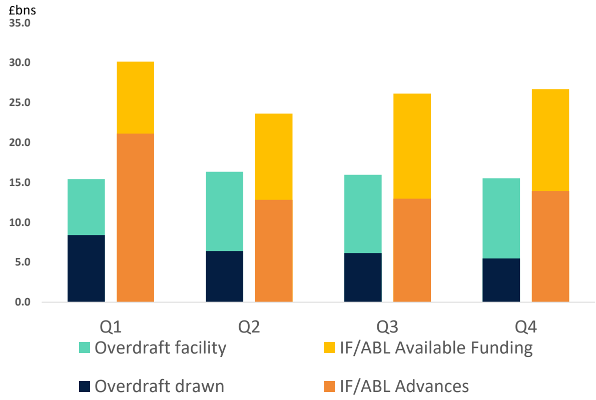
Chart 8: Value of overdraft facilities approved



Source: UK Finance

That said there is still headroom for SMEs within existing overdraft facilities (**chart 9**). In Q4 2020 around a third of overdraft facilities were in use (by value), this is considerably lower than the near 60 per cent utilisation rate that was the norm pre-pandemic. There is a similar story with IF/ABL lending. Again, the was a marked decline in usage of this type of finance last year (see **Box 1**), but there remains a high degree of flexibility within existing facilities.

Chart 9: Overdraft and IF/ABL utilisation



Source: UK Finance

Box: Trends in IF/ABL lending in 2020

Levels of advances to clients through IF/ABL facilities fell dramatically over the year. 2020 opened with members advancing £21 billion to 39,000 clients, which fell to a record low of £12.8 billion at the close of H1 (to almost 38,000 client businesses) before recovering marginally in Q4 to close at just under £14 billion to 36,000 clients. This was the lowest year-end balance for well over a decade.

For IF/ABL clients, turnover is a key metric as sales generally drive availability of finance, as well as providing a useful general economic indicator given the spread of clients across the economy. Total IF/ABL clients' sales for 2020 were £245 billion, down 12 per cent on the 2019 figure which was the fourth highest annual total recorded. Reflecting other data referenced, Q2 represented the trough, with clients recording sales of just £50.5 billion, down 28 per cent on the same period in 2019.

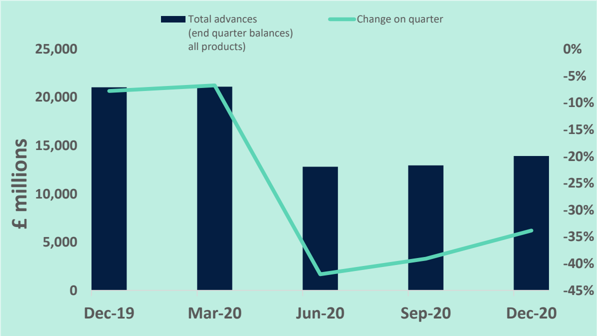
The reduction in client turnover, whilst marked, was significantly less than the dramatic reduction seen in advance levels, indicating that the intensity of utilisation of IF/ABL facilities by the current client base actually reduced over the year. At the close of 2019, clients' available IF/ABL facilities were 71 per cent drawn, with this dropping to under 50 per cent during Q3 before recovering marginally to end the year at 52 per cent. This was a consequence of the government's extraordinary fiscal injections, as well the initial displacement of commercial lending by the government-backed guarantee schemes.

As the intensity of the government interventions taper back, it is likely that invoice finance and asset based lending will come back to the fore in 2021. Finance providers in this sector are diverse and well-funded, with significant capacity to provide more funding to more client businesses as the recovery hopefully takes hold. In addition, an IF or ABL facility can often be deployed alongside other lending facilities which will be important given the increase in debt taken on by many businesses during the pandemic period.

In addition to the IF/ABL industry quarterly data referenced above, additional data was undertaken to monitor the impact of the economic shock on the clients supported by the industry. This analysis allowed the identification of any emerging poor payment practices - such as extended payment terms or unfair contractual practices.

The insight provided into payment days was notable. Debtor payments slowed in April and May, with average payment days increasing by seven in May, reflecting the economic uncertainty. However, reflecting the impact of fiscal measures, they started reducing steadily from June and by the close of the year businesses were actually being paid five days quicker on average than they were prior to the pandemic.

Chart: Advances through invoice finance facilities at quarter-end

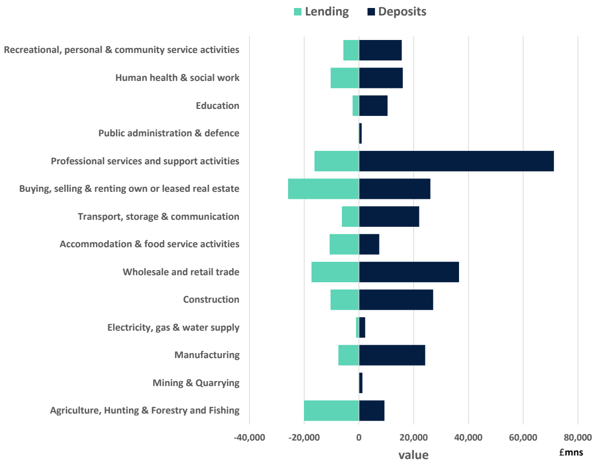


Source: UK Finance

Another very notable shift in the SME finance landscape is the growth in deposits. At the end of last year deposits stood at close to £260 billion, representing a 29 per cent, or £58 billion, increase compared with the end of 2019 (**chart 10**).

Evidence from the SME Finance Monitor shows that a majority of businesses that have accessed finance through government-support loan schemes over the past year have not yet used it. This is consistent with the corresponding increase in the level of deposits seen throughout 2020. In most sectors (**chart 11**) there is a surplus of deposits over borrowing.

Chart 11: Deposits and Lending stock balances as at December 2020



Source: UK Finance

The largest surpluses were found in construction, manufacturing and wholesale & retail trade. In contrast, accommodation & food service companies, as well as agriculture, have, on aggregate, a larger volume of lending than the value of deposits. In the hospitality-related sectors, this is likely a consequence of health restrictions limiting sales and the additional costs of making premises Covid-19-secure.

This is a consequence of not only the widespread use of additional finance that has been made available as a result of the pandemic, but also the pause in a range of outgoings, such as business rates, VAT payments and, in some cases, rent. In addition, the ONS BICS survey shows that many companies have pared back or completely halted investment in response to the crisis.

Outlook for SME Finance

Inevitably the importance of existing reserves will come to the fore as the economy begins to reopen and the range of government support programmes tapers off. As seen in previous periods of recession, pressure on SME finances intensifies at the end of a downturn and early stages of recovery as restart costs and tentative demand pose a significant, and sometimes insurmountable, hurdle for some businesses. The recovery from this recession will be no different and could well come with additional challenges given the ongoing uncertainty about public health requirements, despite the successful roll out of the vaccine.

The introductions of the government's successor scheme to the CBILS and BBLS – the Recovery Loan Scheme (RLS) – which will start rolling out in Q2 2021 will continue to offer some support to businesses looking to recovery. However, there is also evidence from the British Business Bank pointing to concern amongst a quarter of businesses about their ability to repay the finance accessed in 2020.

The sea-change seen in lending to SMEs over the past year in response to the crisis ought to provide confidence that continued engagement between businesses and the finance sector will help support businesses though the period of recovery this year and into next. However, the path and strength of that recovery remains uncertain.

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