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 Q2 2021. It shows how SME demand continued to evolve as the economy began to reopen.

Stephen Pegge, Managing Director of Commercial Finance, comments:

"With the economy reopening in the second quarter and more normal trading conditions in prospect, the finance picture for SMEs has shifted from last year's rapid increase in borrowing, driven by government-backed schemes, to managing repayment obligations.

"The latest data in our Business Finance Review as well as other survey data point to demand for new lending to deal with the pandemic having been largely satisfied. Demand for loans, overdrafts and other finance products has dropped from last year's peak to levels closer to that seen before the pandemic.

"Over a year after government-backed support was introduced, repayments are falling due and SME loan repayments have been accelerating as a result. Industry feedback indicates that most businesses are meeting their obligations or have arrangements in place to manage them, while the recovery takes hold.

"Nevertheless, some concerns about sustaining this are inevitable as some uncertainty about future growth prospects remains. While many SMEs have record levels of deposit reserves and headroom flexibility in existing facilities, those whose resources become stretched should always discuss options for forbearance with the lender. And for those with growth ambitions, funding is available to support expansion and investment."

2021 Q2 HIGHLIGHTS

- **Gross lending to SMEs was £5.2 billion in Q2 2021, down from £7.6 billion in Q1 2021, reflecting declining demand for new funding and falling applications.**
- **Weaker demand led to gross lending continuing to decline across all regions and sectors.**
- **Repayments accelerated in Q2, reaching a series high in June as repayments for government-backed loans began.**
- **Demand for other finance remains muted, with overdraft approvals close to historic lows and utilisation rates lower than before the pandemic.**
- **The total number of IF/ABL clients reduced marginally but overall client turnover recovered strongly and advances also began to rise.**
- **SME deposits rise further over the quarter to stand 13 per cent higher than a year ago.**

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Economic outlook

The backdrop to this quarter's Business Finance Review (BFR) is materially different to that three months ago. Continued momentum behind the vaccine rollout in the UK enabled government to, by and large, stick with its roadmap to lift Covid-related restrictions in England and in the devolved nations. The impact of the gradual reopening of the economy is evident across the spectrum of sentiment and activity indicators in Q2.

The proportion of businesses open and trading again continued to increase through the second quarter, with 86 per cent of businesses surveyed by the ONS trading at the end of the quarter, compared with 73 per cent at the end of Q1. Particularly notable was the rise in reopening of firms in contact-intensive services, which were some of sectors most affected by Covid-19 restrictions. The share of businesses in accommodation and the food service sector trading at the end of Q2, for example, doubled compared with that at the end of Q1.

In line with businesses restarting, activity indicators such as the Purchasing Managers' Indices (PMIs) gathered pace in the three months to June. The average composite indicator (covering all sectors of the economy) recorded its highest reading since the onset of the pandemic, signalling one of the fastest quarters of producer expansion since records began in January 1998. There were significant rises in output and new orders across manufacturing, services, and construction, with businesses more confident that output will continue to rise in the next year as the UK economy recovers from Covid-19. The pick-up in activity has driven increased recruitment activity, in addition to numbers on furlough declining in response to both reopening and the tapering of government support.

Consumers have also played their part in driving activity, with retail and hospitality returning to normal, retail sales rebounded, driven, in part, by a return to physical locations. While there had been some substitution from online sales, the share of online activity remains above pre-pandemic levels. Spend around the Euro 2020 tournament provided a further boost to consumption.

Taken together, positive signals about activity returning and the economy reopening has resulted in tangible gains in official data. The first cut of GDP for Q2 from the ONS showed that the UK economy grew by 4.8 per cent on the quarter – broadly in line with forecasters' expectations. The largest sector contributors to the increase were wholesale and retail trade, accommodation and food services, and education. Construction output expanded again, supported by infrastructure investment, pushing the sector close to pre-Covid-19 levels of activity.

Official data also pointed to a tentative recovery in business investment in the second quarter. Much of this appeared to be driven by increased spend on IT, which is likely to be in support of an expected shift to hybrid working and upgrades as employees return to the office, as well as ongoing investment in digitisation. There is little definitive evidence that the 'super deduction' incentive announced at the Spring Budget is encouraging incremental spend, however, we might expect this to play a role in sustaining an investment recovery as uncertainty wanes. Encouragingly, evidence from the Bank of England Decision Maker Panel suggests this is the direction of travel with the proportion of businesses reporting 'very high' overall uncertainty at the lowest level since February 2020.

Net trade was a weak point in Q2, with imports rising at a faster rate than exports. Nevertheless, exports to EU markets picked up compared with Q1, though this is likely a factor of some EU customers stockpiling ahead of the UK's exit from the EU. While optimism about export demand has improved as the key markets also show signs of recovery from the pandemic, trading challenges remain, including supply chain bottlenecks, reports of rising transport costs and new customs procedures.

There are other clouds on this more positive outlook for businesses. The first half of the year has seen an acceleration in input costs, coming from a sharp increase in prices across a basket of commodities. This will add to pressure on margins in some sectors, as well as prompting some concerns about the prospects for inflation. In addition, there are emerging concerns around labour shortages as firms ramp up hiring at the same time, which could constrain output growth. Labour supply could be further constrained by lower migration and absences caused by new waves of the pandemic.

Expectations for growth in the remainder of the year have continued to improve. The National Institute for Economic and Social Research (NIESR) now expects the UK economy to expand by 6.8 per cent this year, up from its forecast of 5.7 per cent in the Spring. Households are expected to run down some of the savings accumulated over the last year, but the forecast notes that the recovery is not yet broad based, with, for example, trade and international travel lagging. The employment outlook has also improved with unemployment expected to peak at 5.4 per cent, however this still represents an expectation that there will be a jump in job losses when furlough support is fully withdrawn.

Growth momentum should continue through 2022, with UK GDP recovering to its pre-pandemic level at the start of next year. Trade and business investment should make a bigger contribution to growth next year. As has been the case over the past 18 months, the path of the virus – not just in the UK, but globally – continues to present the main downside risk.

SME Finance

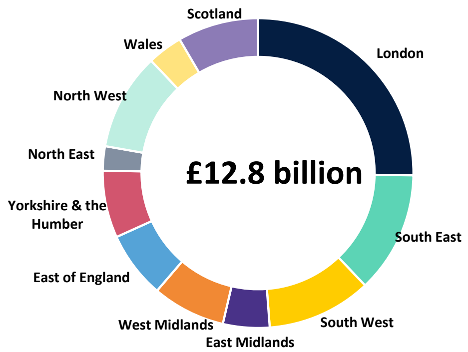
Q2 2021, the period covered by our latest Business Finance Review was the beginning of the end of Covid-19 restrictions across the UK. While the four nations of the UK moved at varying paces to remove social distancing restrictions and reopen the economy, and there was some drift from original timescales, a return to near-normal trading conditions was largely achieved in the summer.

Businesses trading again has also coincided with the beginning of some repayments for government-backed loans being required. Together this had led to a substantial change in the lending picture to SMEs compared with what's been reported over the past year.

Starting with the demand for new finance, applications for loans fell sharply in Q2 following the end of the government-backed schemes. In the three months to June the volume of loan applications was around a quarter of the level seen in the previous quarter and only a fraction of that seen in the peak applications period in the same quarter a year ago.

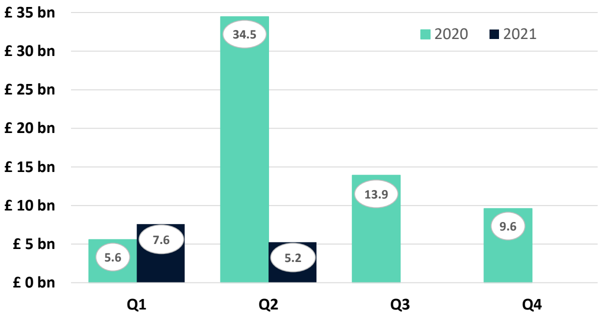
As a result, gross lending in Q2 dropped to its lowest level since the beginning of 2014. In the first half of this year **(*Chart 1*)** gross lending totalled £12.8 billion, this compared with over £40 billion in the first half of 2020. The quarterly profile of lending **(*Chart 2*)** shows the decline in borrowing from £34.5 billion in Q2 2020, when the government-backed loan schemes were introduced, to £5.2 billion in the most recent quarter. The level of lending in Q2 2021 was 31 per cent lower than in the first three months of the year.

Chart 1: Gross lending to SMEs during Q2 2021



Source: UK Finance

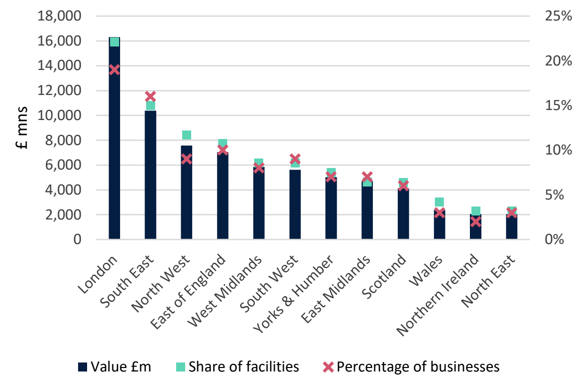
Chart 2: Gross lending to SMEs through loans and overdrafts in 2021 compared with 2020



Source: UK Finance

The government-backed loan schemes underpinned much of the lending activity in 2020. While the schemes officially closed for applications at the end of Q1 2021, some facilities continued to be agreed through Q2. The British Business Bank published the final tally of CBILS and BBLS facilities approved by sector and region and, in line with earlier estimates, the distribution of loans by region was largely in line with the proportion of businesses across the UK (***Chart 3***). By value, businesses in London, the south east and the north west were the largest recipients of BBLS and CBILS loans.

Chart 3: Total value of BBLS and CBILS facilities by region



Source: British Business Bank

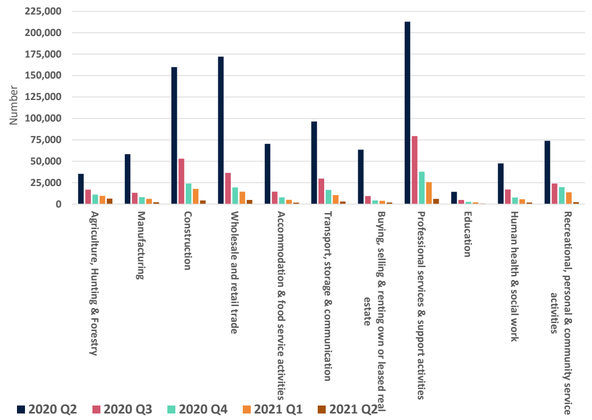
The surge in demand for finance to support business survival through the pandemic was evenly distributed throughout the country and the subsequent fall in the need for additional finance has been similarly widespread. In line with national trends in declining demand for finance, all regions have recorded a similar drop in gross lending over the past year (***Chart 4***). In the three months to June, quarter-on-quarter falls in lending ranged from 21 per cent in Wales to 38 per cent in the East Midlands.

Chart 4: Gross lending by region

Source: UK Finance

And in ***Chart 5*** we can see a similarly consistent picture across industry sectors. The number and value of loans and overdrafts approved, though not the approval rate, has decreased steadily over the past four quarters. The latest SME Finance Monitor confirms that demand for finance has subsided from the peak in the middle of last year, with the proportion of businesses citing plans to apply for finance returning to pre-pandemic levels in Q2 2021.

Chart 5: Number of SME loans and overdrafts approved by sector

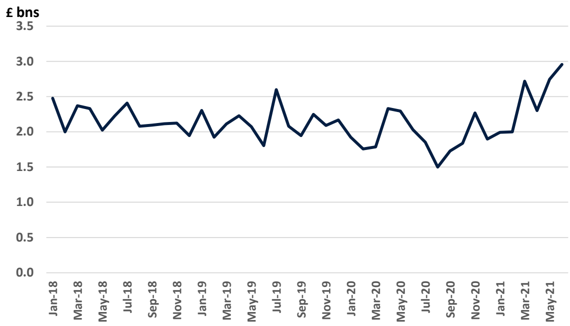


Source: UK Finance

A focus of last quarter's BFR was the notable increase in repayments seen in the first few months of this year. ***Chart 6*** shows that this trend had accelerated in the most recent quarter. Total repayments rose by 20 per cent on the quarter, following an increase of 12 per cent in the previous three months.

This increase in repayments coincides with payments on government-backed loans, particularly BBLs which had payments deferred for 12 months, beginning to fall due over the quarter. As the majority of BBLS and CBILS facilities were taken out in the first few months after their introduction, many businesses accessing these loans will be starting to pay them back.

Chart 6: Value of repayments



Source: UK Finance

Notably, the rise in repayments over the quarter was much more significant amongst small businesses, with a turnover of less than £1 million, compared with medium-sized businesses. The increase in repayments over the quarter for the two cohorts of businesses was 47 per cent and five per cent respectively.

Chart 7: Value of repayments quarter-on-quarter % change

Source: UK Finance

As noted in the Q1 BFR, there is sector variation in repayment activity. Manufacturing and construction were faster out of the repayment starting blocks at the start of the year and the pace of payments in these industries eased in Q2. In contrast, most other sectors have mainly increased the pace of repayments in the past three months. In all sectors the rise in repayments is greater amongst smaller businesses.

While it is still very early days in the repayment of loans accessed through government-backed schemes, the positive trend seen in our data confirms feedback from lenders that where facilities are due for repayment, businesses have made the necessary payments, in some cases repaid the facility in full or have accessed one of the 'Pay as you grow' (PAYG) options available to delay or reduce the level of repayments. These options are likely to be particularly important for those businesses and sectors that have only just returned to more normal trading conditions.

Encouragingly, the latest SME Finance monitor indicates that overall awareness of PAYG options is reasonably high, with a third of total businesses aware of the scheme, rising to 46 per cent of those with a government backed facility themselves. Given many borrowers have yet to start repayments, ahead of which they are contacted about PAYG, this would indicate that industry and government communication as well as direct engagement between lenders and businesses is reaching those that need it.

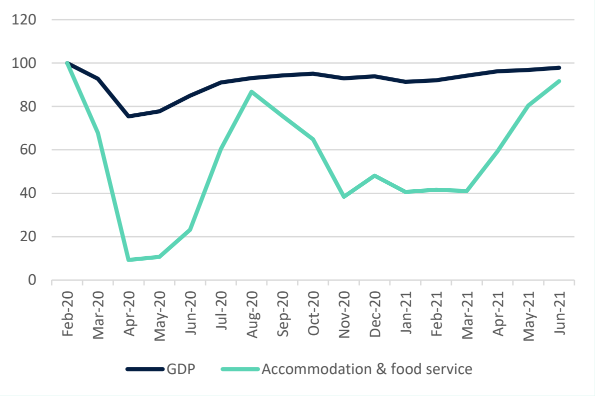
Nevertheless, the SME Finance Monitor also notes that not all businesses are confident about their ability to meet repayment obligations. Amongst those using finance, a fifth were concerned either about repaying traditional facilities or any new Covid-related lending they had taken on, increasing to 30 per cent of those borrowing for the first time. SMEs making a loss were also more concerned about their ability to meet repayments in the next 12 months. The survey also indicates most of those with repayment concerns have been in contact with their lender to discuss repayment options or are in the process of doing so.

Accommodation & food spotlight

Each quarter the BFR focuses on the finance position of a particular region or sector. This quarter the spotlight is on accommodation and food service activities. This sector has been hard hit during the pandemic with many businesses shuttered as restrictions were introduced. With those restrictions largely no longer in force across the UK, we'll take a look at key metrics of activity since the pandemic as well as trends in borrowing and cash deposits.

As ***Chart 8*** *illustrates, output in the accommodation and food service sector has experienced a rollercoaster ride in the past 18 months. Output fell sharply following the first wave of restrictions in early 2020, before showing signs of recovery when these were temporarily lifted last summer and supported by government's 'Eat out to help out' scheme. Activity resumed its downward trajectory during the second wave of Covid-19, and with the economy reopening from April output has again rebounded strongly posting quarter on quarter growth of 88 per cent in the three months to June. Output, nevertheless, stood at over eight per cent below its peak.*

Chart 8: GVA index February 2020=100



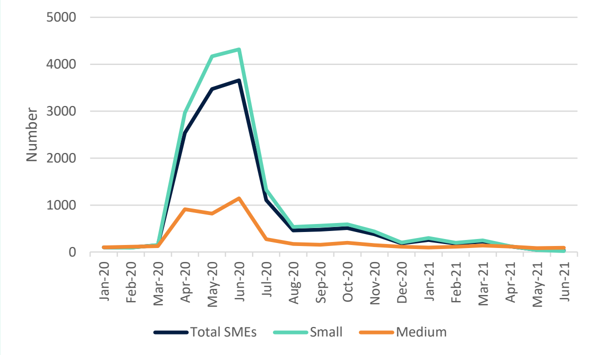
Source: UK Finance

There are positive signs coming from this industry sector. The ONS BICS survey shows a large increase in the proportion of businesses trading again as conditions have begun to normalise with the reopening of the economy. At the end of Q2, 91 per cent of accommodation and food service businesses were trading compared with just 46 per cent at the beginning of the quarter. The proportion of employees on furlough has fallen by 70 per cent over the same period and vacancies in the sector reached a record high in July. In addition, research from the CGA Coffer Business Tracker shows that many hospitality businesses were continuing to benefit from business model changes implemented through the pandemic – such as strong delivery and takeaway sales. That said, some three in ten businesses surveyed by ONS were reporting turnover below normal at the end of Q2.

While the government's furlough support, in addition to the VAT reduction and 'Eat out to help out' scheme, has been important in sustaining the accommodation and food service industry through the pandemic, the sector also drew heavily on government-backed loans. Nearly 126,000 CBILS and BBLS facilities were made available to the sector with a combined value of £6.2 billion. While the sector accounts for 3.7 per cent of all businesses, it accounted for six per cent of the volume of CBILS and eight per cent of BBLS loans.

Analysis of UK Finance data, shown in ***Chart 9****, shows the rapid growth in the volume of loans approved to small and medium sized accommodation and food service business following the introduction of lock down restrictions and the roll out of CBILS and BBLS. Small businesses (with a turnover of less than £1million and accounting for around nine in ten businesses in the sector) were the main driver of the growth in loan approval that occurred between April and June. At the peak in June 2020, loan approvals to small businesses were some eight and half times higher than the monthly average volume of approvals reported in 2019 (approvals to medium-sized businesses was nearly six and a half times higher). Moderation in demand through the remainder of 2020 and the first half of this year means that in the most recent quarter loan approvals are now below pre-pandemic norms.*

Chart 9: Number of loans approved by business size

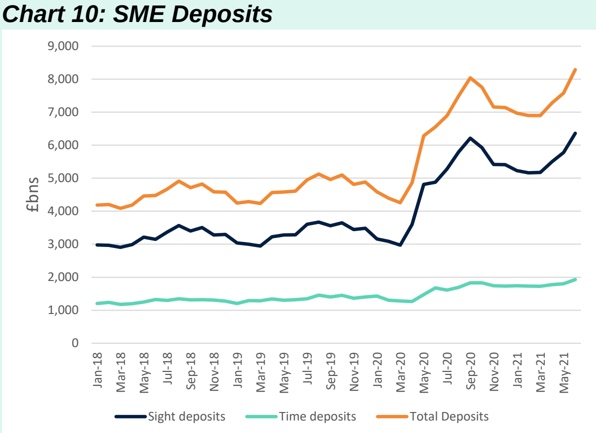


Source: UK Finance

In contrast to the increase in demand for loans, which were the primary government-backed facility type, overdraft approvals have been subdued since the onset of the pandemic as businesses favoured government-supported products. Furthermore, overdraft utilisation rates currently stand at around 25 per cent, significantly below levels seen through 2019 and lower than the whole economy average.

*While the funding available through government-backed loans schemes supported the ongoing survival of many businesses and will likely have helped parts of the industry pivot to new business models to retain customer, the corresponding growth in deposits across the sector **(chart 10)**, suggests not all the money borrowed was deployed. Total deposits in small accommodation and food service businesses more than doubled between January 2020 and June 2021 and recorded a 40 per cent increase amongst medium-sized firms.*

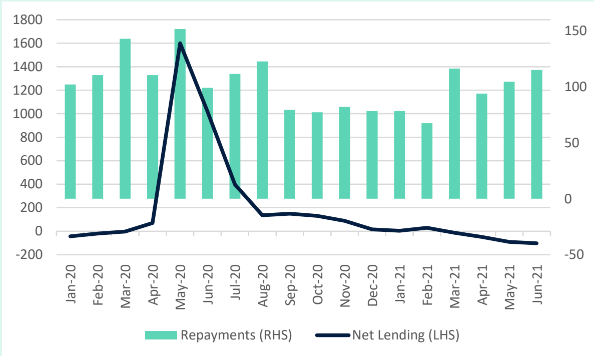
Chart 10: SME Deposits



Source: UK Finance

*A key development over the past quarter has been an increase in repayments **(chart 11)** – there was a pick-up in repayments in March, ahead of first repayments of CBILS and BBLS facilities falling due, with a steady rise through Q2. This trend is apparent across both small- and medium-sized businesses and resulted in monthly declines in net lending since March.*

Chart 11: Repayments and net lending



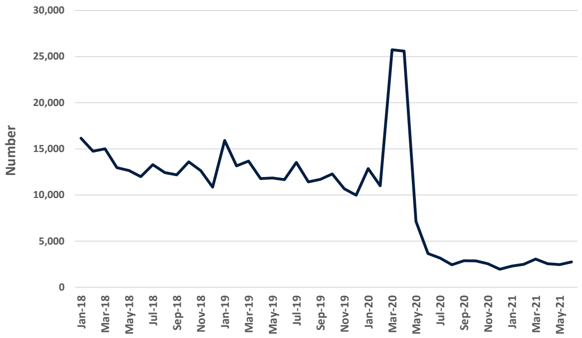
Source: UK Finance

It has undoubtedly been an especially challenging 18 months for the accommodation and food service sector. Trends in lending for the sector over this period suggest it has been well-supported with access to government-backed loan facilities. Recent trends suggests that a recovery is underway, but the experience of 2020 shows how quickly this can be thrown into reverse with a resurgence of Covid-19. Vaccine rollout should minimise the chance of this being repeated in 2021, but restrictions on international travel, will still be creating challenges for some businesses reliant on tourism. The end of the furlough scheme in September could put further pressure on some firms. Like other SMEs, businesses in this sector have, in aggregate, flexibility within existing facilities, and for those that may experience difficulties meeting repayment obligations, it will be important to engage with banks and finance providers on repayment options, such as the Pay as you Grow arrangements available on BBLS facilities.

We have noted the general decline in gross lending and the demand for loans in recent quarters, this is similarly the case for other forms of finance – continuing trends seen in the BFR over the past few quarters. ***Chart 12*** highlights the ongoing weakness in demand for new overdraft facilities. The number of approved facilities fell sharply a year ago as businesses opted for government-backed loans. The proportion of facilities approved has remained largely stable and similar to that seen pre-pandemic, indicating that the low levels of overdraft approved are a consequence of low demand, which shows little sign of turning around or returning to levels seen in 2018 and 2019.

There has also been little notable change in the utilisation of existing overdraft facilities. Nearly 60 per cent of facilities are currently available, broadly similar to that seen over the past year **(*Chart 13*)**.

Chart 12: Number of approved overdraft facilities



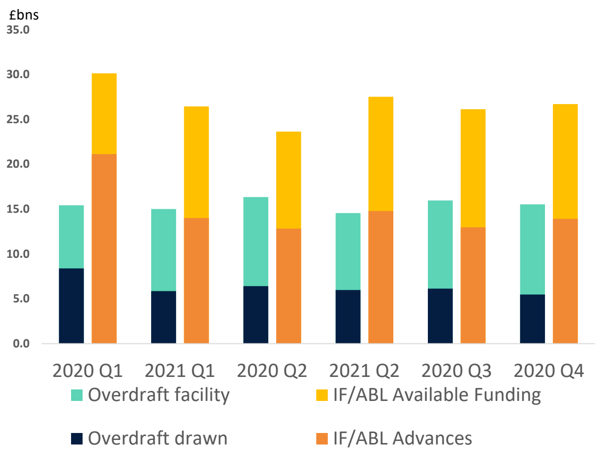
Source: UK Finance

Over the past year we have also seen muted demand for other forms of finance including invoice finance and asset based lending (IF/ABL). As has been the case for overdraft finance, many businesses' funding requirements have been largely met through government-backed schemes. There is little change in this picture over the past quarter. The decline in the overall number of IF/ABL clients has continued - to just under 35,000 from over 39,000 at the end of 2019 - although this is now showing some signs of bottoming out. In the most recent quarter, the decline was concentrated among smaller companies, with a turnover less than £5 million, with modest increases in client numbers being seen in the larger business cohorts.

Overall IF/ABL client turnover recovered in the three months to July, with total client sales up six per cent in Q2 compared with Q1, and 34 per cent up on the nadir that was Q2 2020 when the initial impact of the pandemic on economic activity was felt. Indeed, once the reduction in client numbers is taken into account, it can be seen that businesses supported by IF/ABL facilities have broadly outperformed the general economic recovery, seeing average growth of almost eight per cent during Q2, and bouncing back by some 47 per cent from Q2 2020.

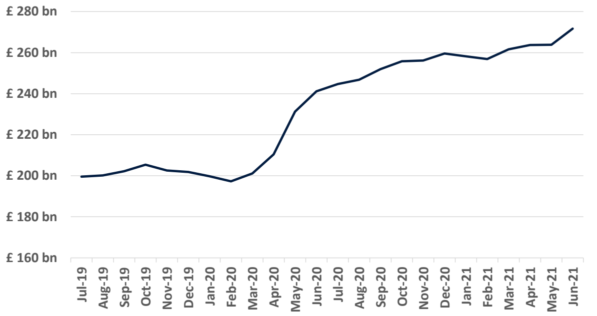
Levels of advances through these facilities have also continued to recover, standing at £14.8 billion at the close of the quarter, up by over five per cent on Q1 and 15 per cent on Q2 2020, although still significantly down on the levels seen pre-pandemic. As noted in previous BFRs, IF/ABL users continue to have a large degree of flexibility within existing arrangements (**Chart 13**) to support cashflow and investment needs, and the sector reports significant capacity to provide more finance to more businesses as the recovery gains momentum.

Chart 13: Overdraft and IF/ABL utilisation



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

Chart 14: SME Deposits



Source: UK Finance

The final piece of the SME finance landscape is deposits. These continued their upward trajectory in the three months to June (***Chart 14***), increasing at a slightly faster pace than in the first quarter of 2021. The total value of SME deposits stood at almost £272 billion, which presents a year-on-year increase of 13 per cent. Compared with the levels seen before the pandemic (in February 2020), total deposits are up by 38 per cent. Three-fifths of those deposits are held in immediate access accounts – a position that has remained largely unchanged compared with that seen before the pandemic.

Outlook for SME finance

The focus on SME Finance, in the short-term at least, is likely to remain on businesses continuing to manage the repayment of lending accessed through the pandemic over the past 18 months. While there are some pockets of concern amongst businesses, healthy levels of deposits, a return to normal operating conditions and flexibility within existing finance arrangements should see the vast majority meeting these obligations. In addition, there are additional flexibilities on repayment schedules that can be agreed with lenders while the recovery takes hold in the coming quarters.

The outlook is not, however, risk free. As noted in the economic context, businesses' ability and confidence to manage their finances is still dependent on the recovery taking hold and consumer confidence holding up. And in addition to loan repayments falling due, other obligations will also start to fall on businesses, for example business rates relief will be reduced from Q3 and the British Property Federation estimates that there is some £7 billion in commercial rent arrears, all of which may bear down on businesses.

Until the impact of reopening is clearer, we do not envisage a material change in the finance landscape for SMEs. The SME Finance Monitor showed a slight uptick in the proportion of businesses saying they would be happy to borrow to grow, the effects of the pandemic still present the main challenge to business performance. And not until this has ebbed are we likely to see sustained recovery in investment.