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 to SMEs in Q4 2021 and across the year as a whole. It shows how SME demand for new finance and repayment activity evolved as the economy continued its recovery from the Covid-19 pandemic.

Stephen Pegge, Managing Director of Commercial Finance, comments:

"2021 was another rollercoaster year for SMEs, right to the end. Encouragingly, we have seen the economy recover back to pre-pandemic levels, though some sectors still have a way to go to close the gap.

"Despite the ups and downs of the past year, SMEs' approach to financial management has been steady. Demand for additional loan finance has stabilised closer to levels seen prior to the pandemic and the value of new lending held up in the final months of 2021. There are signs that alternative forms of finance, such as invoice finance and asset-based lending, have turned a corner in terms of increased demand.

"A good degree of financial flexibility remains. SMEs continue to be able to draw on significant accumulated deposits and have access to unutilised arranged facilities, such as overdrafts, invoice finance and asset-based lending. Meanwhile repayment of the additional finance accessed during the pandemic continues.

"While SMEs will be hoping for more stability this year, a number of challenges will linger, and the finance industry is conscious that these can affect sectors differently. Finance solutions are there for SMEs looking to restart investment plans, boost their working capital or fill a gap if the recovery hits another bump in the road."

2021 Q4 HIGHLIGHTS

- **Gross lending to SMEs stood at £4.8 billion in Q4, broadly unchanged from previous quarter and totalled £22.6 billion for the whole of 2021.**
- **Applications for new loans and overdrafts stabilised in the final quarter of the year.**
- **IF/ABL advances increased by five per cent on the quarter**
- **The value of repayments edged down on the quarter but remain above pre-pandemic levels and were 38 per cent higher in 2021 compared with the previous year.**
- **SME deposits levelled off at the end of 2021.**
- **Overdraft utilisation remains below pre-pandemic levels, providing ongoing financial headroom.**

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Economic outlook

Last November UK GDP finally recovered to levels seen before the pandemic began in early 2020, and while the economy wobbled a little at the end of 2021 as a new Covid-19 variant emerged, the economy ended the year up 7.5 per cent on the previous one.

Most, but not all sectors have made up the ground lost over the past couple of years. Overall, service sector output is 0.5 per cent higher, following growth of 7.4 per cent in 2021. However, consumer-facing services remain well below pre-Covid levels and were further knocked off their recovery path by the Omicron variant, associated plan B restrictions and high level of infections, which depressed activity in retail and hospitality at the end of the year.

Construction activity had a solid end to 2021, expanding by one per cent in the final quarter of the year and posting a record 12.7 per cent annual growth rate for the year as a whole – though this followed an especially difficult 2020. Growth was buoyed by infrastructure, and repair and maintenance work.

The only broad sector not to have returned to pre-pandemic levels of output is production, which comprises mining, manufacturing, and utilities. Trends in manufacturing will be discussed in more detail in our Sector Spotlight, but the industry's growth has been hampered by global supply chain challenges, which continued in the final quarter of 2021. Mining and energy production both contracted at the end of last year.

2021 was another rollercoaster year for the UK and global economy, and the new Covid-19 variant at the end of the year highlighted that pandemic developments still have the potential to knock the recovery off course. While PMIs for services, manufacturing and construction indicate solid new business growth and more optimism about the next 12 months, recent geopolitical developments are a new source of uncertainty.

The war in Ukraine, in addition to the significant humanitarian impact, will be detrimental for the global economy. The conflict is already fuelling large increases in input costs and energy in particular, which look set to push inflation even higher and lead to more persistent price rises through this year.

While much of the focus has been on the impact on households of rising inflation, this also presents challenges for businesses. The latest producer price data shows input cost inflation continues to run at double-digit rates, with businesses seeking to pass through at least some of these increases. Many sectors will also be challenged by sharp increases in energy costs, and they will be without the relative protection of the price cap.

The squeeze on households and the dampening effect that is having on consumer sentiment – likely exacerbated by recent developments – could also present new challenges to consumer-facing sectors. Growing concerns about the outlook for household finances in the year ahead is likely to result in many paring back on non-essential spending.

In addition, some of the emerging recovery challenges we pointed to in the last Business Finance Review (BFR) were still in play in the final quarter of 2021 and look set to persist into at least the early part of this year.

Businesses continue to try and fill vacancies to increase capacity or address worker shortages. The number of vacancies in the economy hit another record high in the three months to January 2022 and the ONS BICS survey showed a third of businesses (excluding those employing fewer than ten people) were experiencing worker shortages, with no sector unaffected. This could constrain some businesses from continuing to bounce back this year.

Vacancy numbers could also fuel higher pay increases across the economy, adding further to concerns about the persistence of inflationary pressures. Headline pay growth has trended down in recent months, but it is far from clear that calls for pay restraint will be heeded, particularly in sectors and occupations where shortages are most acute.

Nevertheless, the overall outlook for the UK economy this year remains one of growth. The average independent forecast for GDP growth this year, as reported by HM Treasury, is 4.4 per cent with private consumption being the primary driver.

However, if prospects for consumers deteriorate, other areas of the economy such as investment and net trade do not look particularly well placed to fill the gap. Many forecasters have already incorporated into their predictions a rebound in business investment spending as Covid-19 uncertainty subsides. Businesses may focus on additional investment in areas that can help address skills shortages, but pressure on margins is likely to limit growth in capital spending.

The outlook for trade is perhaps more concerning. UK exporters have lost ground in recent years. While merchandise exports from the EU were broadly flat last year compared with 2019, the UK's were down some 16 per cent. With further transition arrangements, as a result of Brexit, kicking in later this year, there could yet be further challenges for international businesses to come.

SME finance

It has been a bumpy couple of years for the economy, SMEs, and their engagement with banking and finance sector. This *Review* benefits from data for the whole of 2021 allowing us to compare and contrast the demand for lending and management of finances by SMEs across the Covid-19 pandemic and associated lockdowns.

Table 1 presents the headline lending, repayment, and deposit metrics that we report in our *Business Finance Reviews.* Across all indicators there have been some significant swings, not only compared with 2020, but also compared with that seen before the emergence of Covid-19 in 2019

Table 1: Annual SME finance comparisons

		2019	2020	2021	% change 2020-21
Lending					
	Gross lending £m	24,900	63,600	22,600	-64.5
	Net lending £m	-700	40,400	-9,300	-123
	Loan applications no.	139,300	1,789,700	239,200	-86.6
	Overdraft applications no.	202,100	136,600	43,200	-68.4
	Overdraft utilisation	58%	44%	41%	
Repayments					
	Total repayments £m	25,600	23,200	31,900	37.5
Deposits					
	Sight £m	117,000	158,200	168,300	6.4
	Time £m	84,800	101,400	104,400	3.0

Source: UK Finance
Note: Data rounded to the nearest 100

Demand for finance, as measured by the volume of loan and overdraft applications, fell back sharply in 2021 following the high surge in demand for lending via government-backed loans in 2020. Comparisons with 2019 indicate that loan and overdraft demand took different paths last year, with applications for loans higher than that reported in 2019 as scheme lending supported demand for loans in the first half of the year, but applications for new or increased overdrafts being considerably lower than that reported prior to the pandemic. Moreover, utilisation of existing overdraft facilities declined further in 2021 compared with 2020.

These demand trends have translated into a decline in gross lending in 2021 of nearly two-thirds compared with 2020, but with overall lending last year approaching levels seen in 2019.

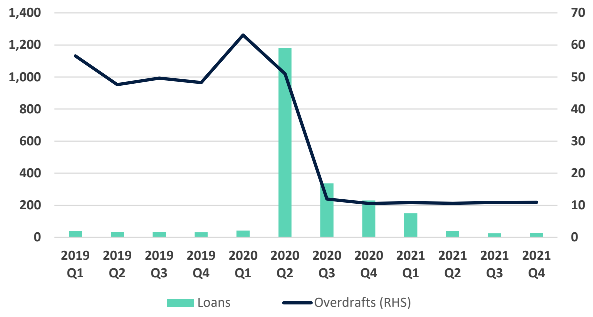
We also saw a notable shift in repayment activity in 2021, with total repayments by SMEs rising by some 38 per cent on 2020 and by a quarter relative to 2019. The rise in repayments last year was driven by the end of the year-long deferral in repayments on Bounce Back Loans (BBLS) and Coronavirus Business Interruption Loans (CBILS), with repayments falling due for around nine in ten government-backed facilities in 2021, unless the SME had accessed a BBLS pay as you grow payment holiday.

The final significant development was the continued rise in SME deposits through last year. At the end of 2021, total deposits were five per cent higher than at the end of the previous year, with growth more prevalent in instant access accounts. This followed deposit growth of almost 30 per cent in 2020 as SMEs accessed available loan schemes but hadn't fully utilised the funds, combined with likely reductions in some outgoings during lockdowns.

2021 Q4 developments

The remainder of the review will focus on developments in the most recent quarter's data. Across the range of finance metrics, trends seen in the final months of last year largely mirrored that reported across the year.

Chart 1: Number if Loan and Overdraft applications (000s)



Source: UK Finance

Chart 1 shows a largely stable picture for demand for finance from SMEs in the final quarter. Applications for loans fell materially following the end of the government-backed BBLS and CBILS schemes in the spring, and has generally continued to be flat in subsequent quarters, including 2021 Q4.

There has been a very high degree of stability in overdraft demand during 2021, with the number of applications averaging just under 11,000 each quarter, with similar consistency in the value of applications.

Notably, application trends across both small (under £2 million turnover) and medium-sized (£2 million to £25 million) enterprises have followed the same trajectory through 2021 and in the most recent quarter.

As we have highlighted previously, the outcome of softening demand for new finance from the early months of 2021 has seen a decline in overall gross lending. The stability in demand in the last quarter of the year has similarly resulted in new lending broadly in line with that reported in 2021 Q3 ***(chart 2)***. And in the latter half of 2021, gross lending was close to levels reported in the years prior to the pandemic.

Chart 2: Gross lending to SMEs through loans and overdrafts

Source: UK Finance

In line with the national picture there has been relatively little movement in lending across regions in 2021 Q4. ***Chart 3*** shows the regional distribution of gross lending. In every region lending is down compared with when government-backed schemes were live, but has been broadly stable in the past two quarters.

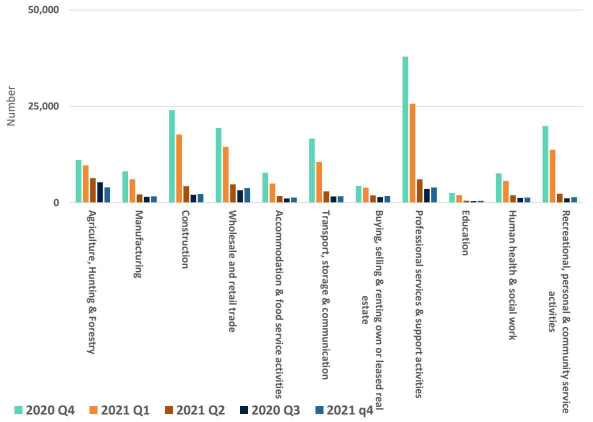
Chart 3: Gross lending by region

Source: UK Finance

A handful of regions saw a modest increase in lending compared with Q3 including the South West and East of England. In contrast, further declines in gross lending were reported in the South East, Wales, Scotland and the West Midlands. Elsewhere new lending was largely unmoved from the previous quarter, but was lower than the start of the year, when government schemes were still in operation. Over 2021 as a whole, the spread of gross lending mirrored the distribution of the business population across the country.

Approval of loans and overdrafts by sector also show relatively little movement in the final months of 2021 ***(chart 4)***. In line with the stabilisation in applications at the end of last year, we see a similar profile in approvals across industry sectors. While there was a slight increase in approvals for businesses in the wholesale and retail, real estate, and professional services sectors in Q4, these remained below levels reported in the first half of the year.

Chart 4: Number of approved loans and overdrafts by sector



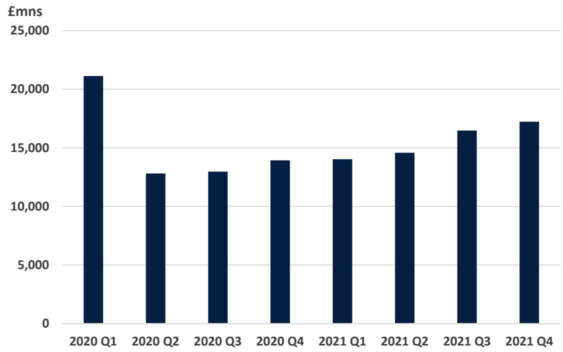
Source: UK Finance

Invoice Finance and Asset-Based Lending (IF/ABL)

We noted in last quarter's BFR that despite the levelling off in demand for loan and overdraft finance, IF/ABL finance looked to have turned a corner in 2021 Q3. The latest data confirms this trend. **Chart 5** shows IF/ABL advances over the quarter since the start of the pandemic. Following a period of relatively stable albeit suppressed demand during the pandemic, when businesses substituted IF/ABL finance for government-backed loans, there are signs of recovery in the second half of 2021.

Advances rose by 11 per cent in Q3 and by a further five per cent in the final quarter of last year. However, at just over £17 billion this remains lower than that reported just before the pandemic.

Chart 5: IF/ABL advances



Source: UK Finance

Note: IF/ABL data includes advances to client businesses of all sizes

Payment times

An oft-discussed challenge to financial management for SMEs is that of 'late payment'. Despite this there is a lack of consensus on the definition of the term and a lack of definitive data. In practice, the term late payment is often used as shorthand for excessive payment times (whether inside or outside of terms) and also a range of what are more properly described as poor payment practices.

But what actually happened with payment times when the pandemic and the subsequent economic disruption hit, and what do we expect to happen as the recovery hopefully takes hold?

UK Finance data shows part of the story. Our data breaks payment days across factoring clients and invoice discounting clients. To note on the representativeness of this sample of UK businesses, it must be emphasised that those businesses that use types of invoice finance will likely have a discipline around credit management that may not be seen in their peers, and in the case of factoring they will have it managed for them by experts. Subsequently, in general one would expect them to suffer relatively less from extended payment times.

Based on the data UK Finance collects from its IF/ABL members – which in turn covers the payment experiences of 35,000 client businesses across the UK economy – as the first lockdown began in the first quarter of 2020 we saw what one would expect when businesses seek to conserve their own working capital in the face of economic uncertainty; payment days began to lengthen.

Mean debtor payment days for clients stood at around 55 days at the end of March 2020 but increased to over 60 at the end of April and then almost 63 at the end of May, a level not seen since 2007/8. But as the various government fiscal interventions to preserve businesses kicked in, payment days began to drop, returning to pre-pandemic levels by July and continuing to drop far below to bump along in the high 40s or low 50s for the following 18 months – unprecedently low levels.

This means that at the height of the economic disruption caused by the pandemic, after an initial spike, this sample of businesses were being paid up to ten days sooner than they were before Covid-19 struck. The potential reasons for this reduction will likely include the liquidity injected into the market through the government lending schemes, Job Retention Scheme, deferred VAT and other interventions.

At the same time, other studies report continuing challenges, with research from the Chartered Institute of Credit Management (CICM) and Pay.UK reporting half of smaller businesses suffering from late payment in 2020, though admittedly down on 2019, and the Federation of Small Businesses (FSB) finding that as many as 400,000 small firms might collapse as a result of late payment in 2022. The picture is, therefore, not clear and businesses of different sizes and in different sectors are likely having very different experiences.

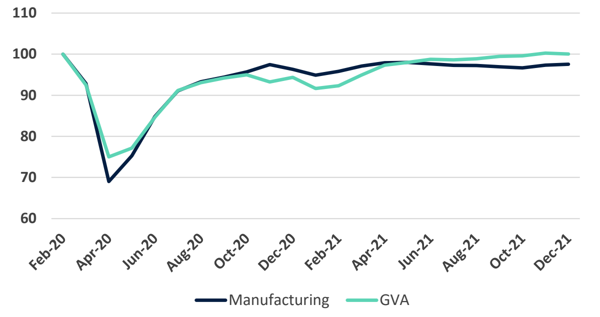
SPOTLIGHT: MANUFACTURING

Each quarter the BFR focuses on a particular region or sector. This quarter the spotlight is on manufacturing. The industry rebounded faster than the economy from the first lockdown in 2020 but has since been hampered by global supply chain disruptions.

***Chart 6** shows that manufacturing output was harder hit than the rest of the economy in the early days of the Covid-19 pandemic but bounced back more quickly in the latter part of 2020 as businesses were able to operate more normally than those in some service sectors, for example.*

However, this recovery was knocked off course somewhat last year as supply chain constraints, particularly in the transport sectors, impacted on production. Vehicle manufacturing, for example was still nearly a quarter lower at the end of 2021 compared with 2019 Q4. Stripping out automotive, manufacturing output was just 0.4 per cent below pre-pandemic levels. In contrast, pharmaceuticals output has surged as a result of vaccine production and the food manufacturing sector has been largely stable due to sustained demand through the pandemic.

Chart 6: GVA index February 2020=100



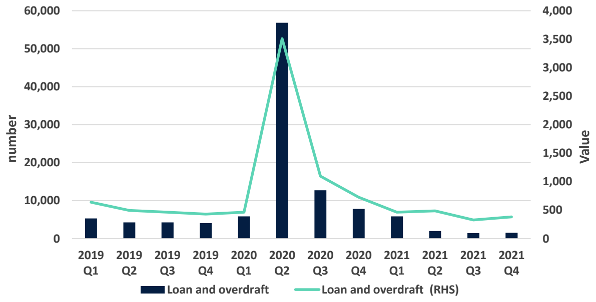
Source: ONS

Surveys at the start of this year point to an improving outlook, suggesting that the worst of the supply chain problems may have passed. However, cost pressures are significant across the industry, with the latest data continuing to show manufacturers are facing double-digit increases in input prices. For some sectors, the rising price of energy will be particularly concerning. The recent ONS BICS survey also noted that the sector has faced additional costs from the end of the EU transition period. Like many other sectors, manufacturers are also facing challenges with recruitment. Nevertheless, manufacturing businesses appear somewhat more confident than average about future survival.

Manufacturers made significant use of the government's BBLS and CBILS loan schemes through the pandemic. Data from the British Business Bank (BBB) shows that despite accounting for around five per cent of the business population, the sector accounted for 14 per cent of CBILS facilities and six per cent of BBLS.

*Analysis of UK Finance data, shown in **Chart 7**, shows the rapid growth in the volume and value of loans approved to manufacturers following the introduction of the government loan schemes. The value of loans and overdrafts approved in 2020 was almost double that in 2019, however the path of approvals last year trended down, in line with that seen in the rest of the economy. Moreover, the bulk of approvals in both 2020 and 2021 were for loan financing with overdraft demand considerably down on that seen prior to the pandemic. Similarly, overdraft utilisation, which has historically been lower in manufacturing than the economy average, has also reduced since the onset of Covid-19 and remained at lower levels than that seen before the pandemic at the end of 2021.*

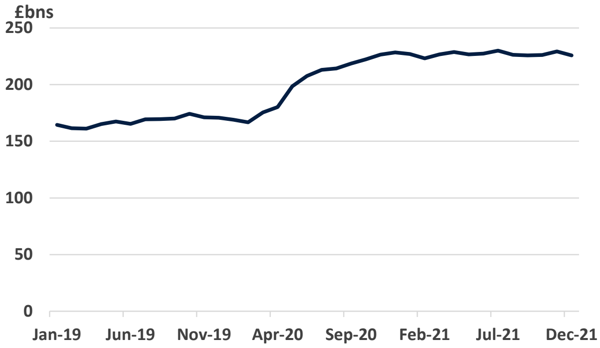
Chart 7: Loan and overdraft approvals,



Source: UK Finance

Manufacturers, similar to businesses in other sectors, accumulated significant deposits *during 2020. At the end of 2020, deposits were a third higher than at the end of the previous year. However, manufacturers' deposits have seen a flatter trend through 2021 than the rest of the economy, actually ending the year lower than where they started 2021* ***(chart 8)****.*

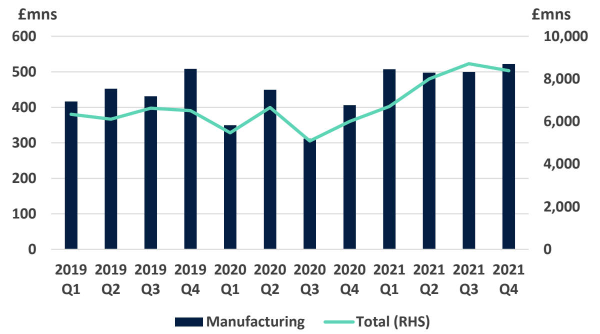
Chart 8: SME Deposits



Source: UK Finance

A focus in recent BFRs has been the shift in repayment activity as companies have started to pay back BBLS and CBILS during 2021. Again, manufacturing repayment trends across 2021 were broadly similar overall to that seen in the rest of the economy, with total repayments 34 per cent higher compared with the previous year (38 per cent in the whole economy). ***Chart 9*** *shows the quarterly profile of repayments for the sector, and there is a slight difference compared with the rest of the economy.*

Chart 9: Repayments



Source: UK Finance

Manufacturers' repayments picked up sooner than in the wider economy, showing the first marked increase at the end of 2020. Cumulative growth in repayments in 2020 Q4 and 2021 Q1 was stronger than average, with the level of repayments stabilising in subsequent quarters.

There are a couple of potential factors behind this profile. Firstly, the somewhat earlier initial rebound in activity, providing some confidence for businesses to pay down loans that were perhaps not fully utilised during the pandemic. Secondly, the disproportionate borrowing by the sector under the government schemes.

Overall manufacturing has had a bumpy ride, particularly through 2021 as parts of the sector were more exposed to global supply disruptions. As an internationally-focused sector, adapting to Brexit challenges has also brought additional costs and challenges. Nevertheless, the finance behaviour of SMEs in the sector has not been materially different from that seen elsewhere in the economy.

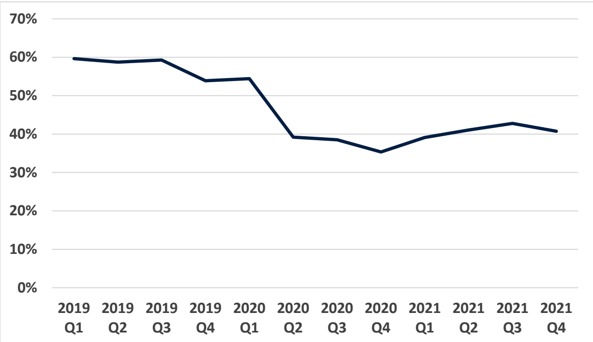
It is also a capital-intensive industry and adoption of new technologies and replacing obsolete equipment, likely delayed during the pandemic, could result in additional finance requirements in the coming years.

Financial headroom

Alongside the additional finance capacity that remains available through IF/ABL facilities, SMEs continue to have headroom within existing overdraft facilities and through accumulated deposits. This picture of a degree of financial flexibility for SMEs was consistent through 2021.

As we showed earlier, demand for new or increased overdrafts fell sharply as government-backed loans were introduced in 2020 and show no signs of recovery. In addition, there is so far little sign of businesses making more use of existing facilities. Utilisation rates continue to hover close to 40 per cent ***(chart 10)***, providing headroom for businesses to manage cashflow and day to day expenses.

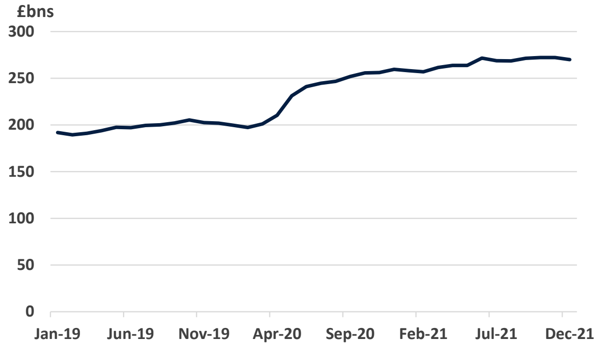
Chart 10: Overdraft utilisation, percentage



Source: UK Finance

SMEs also continue to hold significant deposits, certainly compared with the pre-pandemic years ***(chart 11)***. However, it appears that deposit growth may now be behind us. The level of SME deposits has stabilised at a shade over £270 billion in the past seven months and edged down in December 2021. As businesses return to more normal operations, begin to pay down loans accessed during the pandemic - in addition to managing some large price increases - opportunities to further build deposits are more limited.

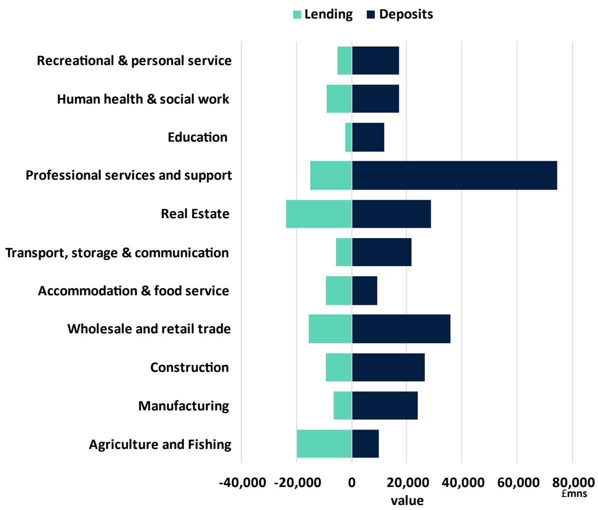
Chart 11: SME Deposits



Source: UK Finance

As has been the case with most metrics reported in this BFR, there is little sector deviation from the national picture, aside from the usual seasonality in agriculture and slightly more marked declines in December 2021 in accommodation and food activities and recreation and personal services – this may be related to the fall off in activity in these sectors due to the emergence of the Omicron variant.

Chart 12: Net position



Source: UK Finance

Contrasting lending and deposits across sectors ***(chart 12)*** the picture continues to be one of deposits exceeding debt, and in most cases by a considerable margin. The exception is agriculture, though this is unrelated to the events of recent years and the situation is more marginal in accommodation and food activities.

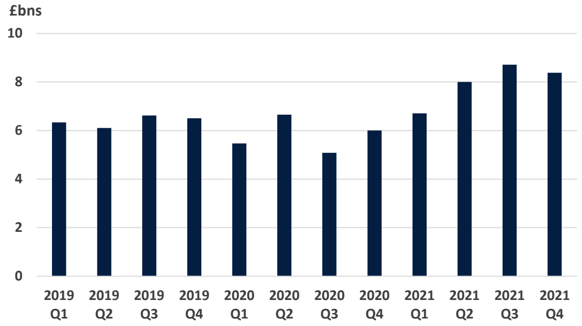
Repayments

Finally, repayments continued apace in the final months of 2021 as shown in ***chart 13.*** This continued the trend seen since the turn of last year, as repayments on government-backed loans began to fall due. While the quarterly total in 2021 Q4 edged down slightly compared with the previous quarter, it nevertheless remains elevated compared with averages reported in 2019.

With repayments on government-backed loans baked in for the next few years, this trend should be with us in 2022 and beyond.

While repayments by smaller companies (with a turnover of up to £2million) accelerated at a faster pace compared with medium-sized businesses at the start of 2021, the trajectory of repayments was consistent between the two cohorts in the second half of 2021.

Chart 13: Total repayments



Source: UK Finance

Outlook for SME finance

Demand and supply of business finance was stable in the second half of 2021, even as businesses responded and adapted to new and ongoing challenges.

These challenges should dissipate but not disappear in 2022. Cost pressures, economic uncertainty and, for some industries, the ongoing response to the Brexit transition, will likely be part of our narrative in the year ahead. In contrast to how SMEs have emerged from previous crises, the underlying financial position is relatively solid, with cash reserves and unutilised facilities on hand.

We also hope to see a recovery in investment that will contribute to ongoing improvements in productivity and meeting customer demands- and for that there are a range of financial solutions that SMEs can tap into. This is critical in supporting the foundations for longer term growth among small businesses.