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 2021 Q1. It shows how SME demand continued to evolve through the Covid-19 pandemic and ahead of the economy beginning to re-open in the spring.

Stephen Pegge, Managing Director of Commercial Finance, comments:

"As businesses entered 2021, many restrictions that had curtailed activity through much of 2020 were still in place. A substantial number of businesses had access to government support, including that provided through the finance sector to navigate the crisis.

"In the first quarter of 2021, the lending environment was broadly stable. Gross lending was elevated compared with pre-pandemic levels, but had tapered back from the peak seen last summer. Ahead of the economy reopening businesses were continuing to meet their finance needs with a combination of 'business as usual' lending and that still on offer through government-backed schemes. SMEs continue to have facilities available through overdrafts and IF/ABL products, which should offer some financial flexibility to businesses managing the restart.

"While the economic picture is looking more positive, we expect a multispeed recovery across different segments of the economy. This will drive differences in future demand for additional finance, debt repayments and growth plans across businesses. The financial services sector will work across these groups to provide the right support through normal lending channels and RLS, to those that need it as the economy reopens and the recovery gains traction this year."

2021 Q1 HIGHLIGHTS

- **Gross lending to SMEs was £7.6 billion in 2021 Q1, lower than last quarter but higher than pre-pandemic norms.**
- **Tapering in demand for finance seen across sectors and regions of the UK.**
- **Demand for overdrafts remains muted, but approval rates steady and consistent with that seen before the pandemic.**
- **SME cash deposits continue to rise in Q1, but at a slower pace than recorded through 2020.**
- **Utilisation of overdrafts and IF/ABL finance remain lower than in 2020 Q1, providing financial headroom for SMEs.**
- **Signs of some increase in loan repayments, particularly amongst smaller business and faster growing sectors.**

Economic outlook

The UK economy continued to operate under Covid-19 restrictions in the first quarter of this year – the period covered by the latest *Business Finance Review.* And with limitations on activity still facing many sectors of the economy, output contracted by 1.5 per cent. This followed a return to growth in the previous two quarters, as public health restrictions were temporarily eased. The sectoral composition of growth has, largely, been determined by the extent of applicable restrictions. In 2021 Q1, the services sector contracted by two per cent, production fell by 0.4 per cent, but construction rebounded by 2.6 per cent compared with the previous quarter.

Despite nationwide restrictions on many businesses during this period, the overall fall in GDP was less than expected as businesses adapted to limitations on activity and developed new ways of operating. Moreover, the monthly GDP releases from ONS pointed to some return to growth in February, with subsequent strengthening in March and April as restrictions began to be lifted.

Survey evidence from businesses has also been more encouraging in recent months. The Office for National Statistics (ONS) Business Impact of Coronavirus Survey (BICS) showed that at the end of the first quarter 75 per cent of businesses that had not permanently closed were currently trading. As limitations on business activity have been gradually eased, this has increased to 87 per cent in the most recent wave (32) of the survey.

Additionally, the BICS survey also notes that the proportion of businesses reporting turnover below normal has also been gradually decreasing. Similarly, labour market indicators point to some recovery in recruitment, with vacancies rising across most sectors as businesses meet staff requirements ahead of reopening.

An area of weakness at the start of this year was the UK's trade performance. Goods exports contracted by nearly 12 per cent in the first three months of the year, in part a consequence of some stock-piling activity ahead of the end of the Brexit transition period. There were signs of this decline unwinding in April with a pick-up in exports to the EU.

While the supply chain disruptions caused by the pandemic are likely still affecting global trade, survey evidence does suggest that some businesses are grappling with the practicalities of the UK's exit from the EU, notably increased paperwork and changes to transportation costs (BICS wave 32). In addition, respondents to the Bank of England's Decision-maker Panel survey estimate that Brexit will contribute to investment being two to three per cent lower than would otherwise have been the case this year and next.

Business investment has been hit hard through the pandemic. In 2021 Q1 investment fell by nearly 12 per cent and was 18 per cent below pre-pandemic levels. Despite signs of improving activity investment intentions remain weak and are unlikely to strengthen until businesses are more confident about the durability of the UK and global recovery. However, the additional tax incentive to invest announced in the March Budget could accelerate some investment plans.

Confidence amongst businesses is, nevertheless, gaining ground. Both the manufacturing and services PMI, in addition to reporting solid growth in overall activity, also note levels of optimism about short-term business prospects at or near historic highs.

These factors have contributed to forecasters pushing their expectations for growth in the UK economy higher this year. The average independent forecast reported by HM treasury for GDP growth this year was 6.7 per cent, up from 4.7 per cent in March – making up some of the lost ground over the past 15 months.

While the outlook is more positive for businesses than has been the case for some time, many businesses will nonetheless be approaching the reopening of the economy in a fragile state after more than a year of restrictions. The challenge of uncertainty around the spread of Covid-19 may persist until global vaccination rates increase. In addition, new challenges will emerge with recovery. The end of the government support schemes is in sight, which we discuss later, and it is currently unclear how vulnerable businesses might be in the absence of these schemes. The consequences of Brexit will continue to cast a shadow over some sectors, at least in the near term.

SME Finance

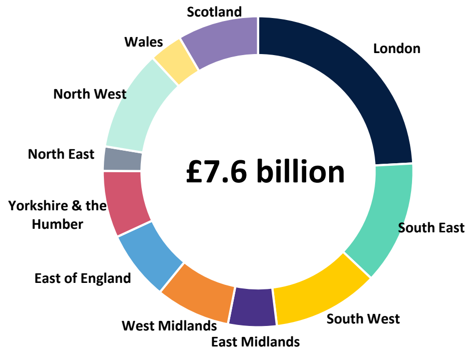
With businesses and consumers still living with the Covid-19 pandemic in the early months of 2021, and the associated restrictions that were reintroduced at the end of last year, trends in business finance carried on in much the same vein as that seen in the final months of 2020. New lending remained elevated compared with pre-pandemic norms, but the increases in gross lending continued to slow from the peak seen in 2020 Q2.

During the period covered by this BFR, government-backed loan schemes were still in play, with businesses able to apply until the end of March. Additionally, other support remained in place, such as the furlough scheme and tax deferrals, as some sectors were effectively shuttered or at least faced significant constraints on activity due to social distancing requirements and other restrictions.

The data and commentary in this review provides a snapshot of the financial situation of small and medium-sized businesses ahead of the reopening of the economy, which began with some retail and hospitality opening their doors again in April.

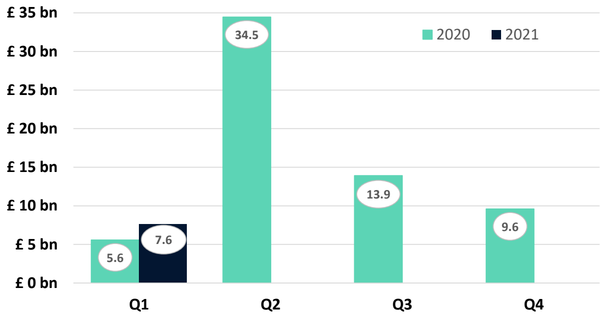
The latest data on gross lending in 2021 Q1 shows demand for new finance continued to taper off from last year's high, with gross lending of £7.6 billion **(*Chart 1*)**. While this was around a fifth lower than the previous quarter, it nevertheless represents a 36 per cent increase on the same quarter a year ago **(*Chart 2*)** and follows substantial growth through 2020 as a whole, driven in large part by banks and other finance providers ensuring businesses had access to government-backed support.

Chart 1: Gross lending to SMEs during 2021 Q1



Source: UK Finance

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

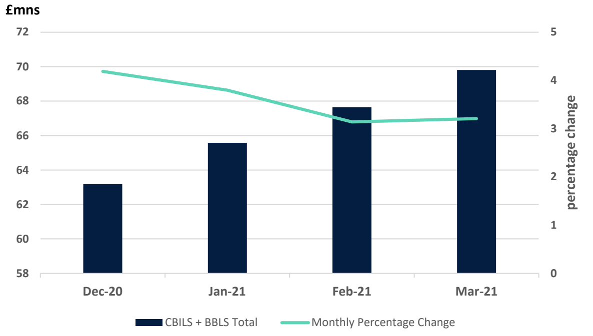


Source: UK Finance

Elevated demand for lending compared with that seen in the years leading up to the pandemic tally, with survey evidence from the SME Finance Monitor in Q1, which showed that the proportion of SMEs using external finance stood at 42 per cent, largely unchanged from the previous quarter, but up from the 30 per cent using external finance at the start of last year.

As we have highlighted in previous BFRs, much of the lending through 2020 was supported by government-backed lending schemes. While this support was still open for applications until the end of March, data suggest there was not a dash to access it before the deadline. HM Treasury data **(*Chart 3*)** point to stable monthly increases in CBILS and BBLS lending in the first three months of the year. While banks continued to process applications for these schemes into Q2 provided businesses got in ahead of the deadline, anecdotal feedback does not indicate a significant increase in demand ahead of the scheme closure.

Chart 3: CBILS and BBLS values (LHS) and month-on-month change



Source: HM Treasury

Lending levels therefore reflect a combination of SMEs continuing to access the government support available through the finance sector and 'business as usual' lending, both to meet additional financing needs and some likely restructuring of debt ahead of restrictions ending and business restarting.

As reported in previous BFR reports, trends in approved loan applications have been largely consistent across sectors and regions **(*Charts 4* *and* *5*)** and this continued to be the case in 2021 Q1.

Looking first at the regional distribution of lending, the slowdown in new lending – a result of tapering in demand – is seen across all parts of the UK. In line with the aggregate national picture, the value of gross lending in every region was down on that reported at the end of last year, but higher than that seen in the quarters leading up to the pandemic.

Chart 4: Gross lending by region

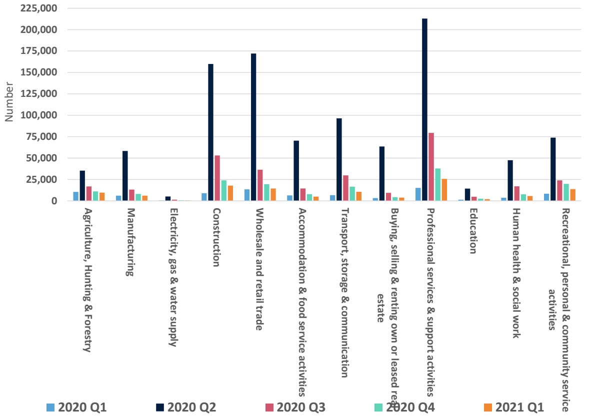
Source: UK Finance

Inevitably, the volume of gross lending by region continues to reflect the distribution of the business population across the country, with London and the South East of England seeing the highest share of new lending, a reflection of the large share of businesses operating in these regions.

Similarly, the industry sector picture follows the same pattern, with a drop off in lending applications and therefore the total approvals at the start of this year across all sectors. The quarter-on-quarter slowdown in lending approvals across all industries is broadly in line with the national average, despite the variation in economic performance seen across sectors in recent quarters; a consequence of the varying impacts of the pandemic restrictions on businesses' ability to trade, as discussed in the economic outlook. For many sectors, particularly those facing the most severe restrictions on operations at the start of this year, other aspects of government support such as the furlough scheme, business rate holidays, VAT deferrals and grants will have been as important as access to finance in helping business survival through the pandemic.

Again, the slowdown in approvals is reflective of the profile of SME demand for finance. The latest SME Finance Monitor continues to point to high rates of approval for finance at the start of this year, with nearly nine in ten (87 per cent) businesses reporting that their lending application was successful in the year to 2021 Q1. This is in contrast to the relatively lower levels of confidence amongst SMEs that applications will be approved.

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



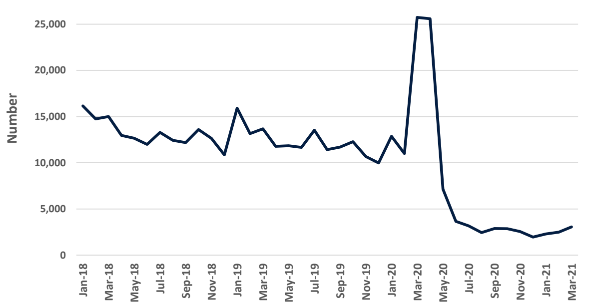
Source: UK Finance

Another significant development in the external finance landscape for SMEs over the past 18 months has been the waning demand for overdrafts. A trend that, again, persisted at the start of this year. Overdraft applications collapsed, and correspondingly the value of approved facilities during the second quarter of last year **(*Chart 6*)**, this coincided with the introduction of the government-backed loan programmes.

Following the sharp decline in applications and approvals in the second half of last year, demand has remained subdued but stable in the early months of this year, with relatively little month-on-month movement. As with sectoral trends in overall lending applications, the weaker demand for new overdraft facilities is replicated across all industries as businesses have tapped into other sources of finance (including the government-backed schemes) to meet any cashflow requirements.

Nevertheless, as we noted on lending approvals more broadly, our SME finance data notes that the proportion of applications for overdrafts that were successful has held steady at over seven in ten, similar to rates reported in the quarters before the pandemic.

Chart 6: Value of overdraft facilities approved



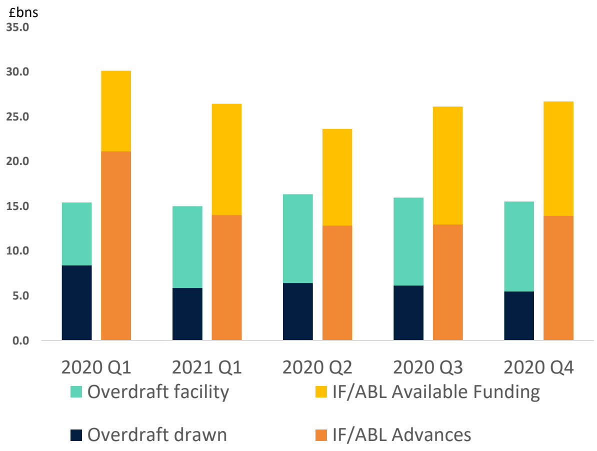
Source: UK Finance

Even with lower levels of overdraft applications for new facilities, we continue to see a large degree of headroom within existing overdrafts **(*Chart 7)***. In the first three months of this year the overdraft utilisation rate stood at 39 per cent, consistent with rates seen since the onset of the pandemic but considerably down on the 60 per cent utilisation rates recorded through 2018 and 2019.

Similarly, and as has been the case with most types of non-scheme lending, IF/ABL lending showed a marked drop in usage of these types of finance last year, which continued into the start of 2021. However there remains a significant amount of headroom within existing facilities.

IF/ABL advances have seen a modest recovery, which continued in Q1 following the sharp fall seen at the outset of the pandemic. Advances stood at just over £14 billion in the three months to March to just over 35,000 clients. As with overdrafts, the intensity of usage has also declined through the pandemic, with utilisation falling back from around 70 per cent at the beginning of last year to just over half in the current quarter. As we highlighted last quarter, finance providers in this sector continue to have capacity to increase funding to clients as sales return and the recovery gathers momentum through this year and into next.

Chart 7: Overdraft and IF/ABL utilisation

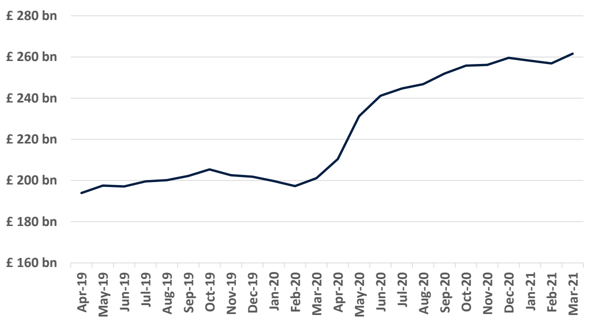


Source: UK Finance

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

A third area of financial flexibility available to SMEs is the level of deposits. In recent BFRs we have tracked the rapid increase in deposits. Quarter-on-quarter increases were particularly robust in the second and third quarters of 2020, as businesses accessed government-supported loans but had yet to fully deploy them. Following the surge in SME deposits in the middle of last year, growth has continued, albeit at a more subdued pace **(*Chart 8*)**, including in the most recent quarter when the rise in the value of deposits was just under one per cent compared with the previous three-month period.

Chart 8: SME Deposits



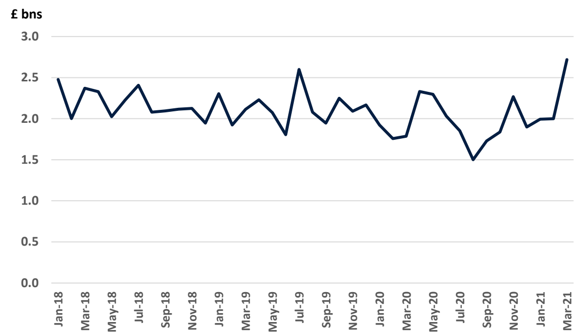
Source: UK Finance

Our data again aligns with trends reported in the SME Finance Monitor, which reported that SMEs held the equivalent of 34 per cent of turnover in credit balances, the highest seen to date in the survey in 2021 Q1.

A new area of analysis in this quarter's BFR is trends in repayments. With unprecedented levels of borrowing driven by the pandemic, policymakers' attention is also focused on the ability of businesses to meet their debt obligations. This has underpinned a range of new support measures, such as various repayment options – Pay as you Grow – available to businesses that accessed funding through BBLS.

While the ONS Business Impact of Coronavirus Survey (BICS wave 31) showed a majority of businesses reporting moderate or high levels of confidence that they will be able to meet future debt obligations, around a fifth were unsure. In our Q1 data we see some early evidence of an increase in repayments by SMEs **(*Chart 9*)**.

Chart 9: Value of monthly loan repayments

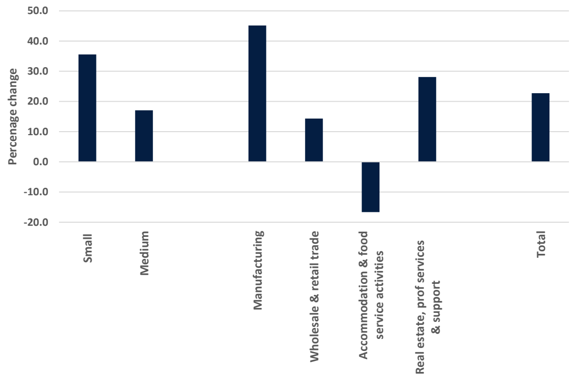


Source: UK Finance

Loan repayments by businesses increased at the start of this year, with a majority of the total repayment increase coming in March. Compared with the same quarter a year ago, repayments by SMEs were up by nearly a quarter (23 per cent). As **Chart 10** illustrates, there are differences across sectors and between small and medium-sized businesses. Smaller companies were more likely to see an increase in repayments compared with their medium-sized counterparts. This may reflect an aim to start reducing debt levels, even ahead of repayments for government-backed loans commencing and potentially an appetite to return to pre-pandemic levels of external borrowing.

In addition, the data reveals some notable sector differences in repayment trends, with manufacturing, wholesale & retail and construction (not shown) amongst those industries recording the largest increases in repayments at the start of this year. Underpinning this could be a number of factors. For example, these sectors have fared relatively better in recent quarters in terms of growth and improvements in business confidence. Additionally, sectors such as manufacturing and wholesale & retail borrowed disproportionately through government-backed schemes, compared with their share of the economy. If this was a precautionary step, businesses may be opting to pay down the debt and rely on internal finance for operating costs or investment.

Chart 10: Change in monthly loan repayments by selected business size and sector, three months to March 21 on a year ago.



Source: UK Finance

This data on repayment offers a short-term snapshot of SME activity, overall repayment data and insights from businesses making use of the 'Pay and you Grow' options in the coming quarters will provide more detail on how businesses are managing their finances and repayment obligations. For some, with the economy not fully reopened, further engagement with finance providers and advisors may be helpful in determining the best course of action, particularly if navigating further periods of uncertainty is necessary.

Outlook for SME finance

As the economy reopens and economic recovery gathers momentum, this should help many sectors and businesses regain a more stable footing. Our BFR has highlighted some degree of headroom amongst SMEs to manage the restart of operations within existing finance arrangements, as costs and pressure on cashflow are likely to increase.

The SME Finance Monitor suggests that future demand for finance has stabilised since last spring and businesses requiring additional resources will be able to approach lenders for 'business as usual' lending or the Recovery Loan Scheme.

The key risk remains the ongoing uncertainty about the pace and irreversibility of the reopening of the economy. However, this is diminishing as momentum behind the UK's vaccination programme has been maintained into the summer.

That said, with the end of public health restrictions in sight, so too is the end of the public support that has been available to businesses. The furlough scheme will end in September, business rates holidays relief across selected sectors will taper off to April next year and around £34 billion in VAT payments have been deferred (albeit with government reporting a significant portion of this having since been paid back). Many businesses will also have deferrals in place for rent on premises. The next challenge for some businesses will be managing through the end of this support while investing in other, longer-term business priorities. The support that the finance sector has provided to business thus far through the pandemic will evolve with economic conditions and ongoing engagement with the SME sector will continue in order to support the emerging recovery and help businesses manage their finances and growth plans.

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