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 at the start of 2022 as Covid-19 restrictions ended, but the UK and global economy entered a new period of uncertainty with conflict in Ukraine and escalating cost-of-living pressures on households.

Stephen Pegge, Managing Director of Commercial Finance, comments:

"Activity across the economy continued to expand at the start of the year, but SMEs were beginning to face a pick-up in economic headwinds. While concerns about household finances have been making headlines, many businesses are also dealing with sharply rising input costs and more uncertainty about the demand outlook.

"Nevertheless, finance usage and demand by SMEs shifted little in the early months of 2022. Overall lending has been broadly stable, but there has been a pick-up in new overdraft approvals and utilisation in addition to continued growth in invoice finance and asset-based lending advances. This is likely a response to the now complete reopening of all parts of the economy as well as the increase in cost pressures.

"Our data continues to show that SMEs are meeting repayments of government-backed loans, accessed during the pandemic, but this has not significantly dented the financial headroom available through deposits and flex in other arrangements."

2022 Q1 HIGHLIGHTS

- **Gross lending to SMEs stood at £4.9 billion in Q1, £0.1 billion higher than the previous quarter.**
- **Q1 saw the first material increase in overdraft approvals in two years, driven mainly by applications from small companies.**
- **Overdraft utilisation also edged up to the highest level since April 2020, but it remains below pre-Covid-19 trend.**
- **Invoice Finance/Asset-based lending (IF/ABL) advances continue to rise with a further ten per cent increase in Q1.**
- **Repayments remain firm in Q1, increasing slightly from the previous quarter and underpinned by higher repayments by medium-sized firms.**
- **SME deposits declined for the third quarter running, but by a modest 1.4 per cent. They remain significantly above pre-pandemic levels.**

Economic outlook

After emerging from the Covid-19 pandemic quite robustly in the second half of 2021, growth stuttered at the start of 2022. A new Covid-19 variant and a rapid increase in inflation, driven by a combination of rising global demand and supply chain bottlenecks, further exacerbated by the Russian invasion of Ukraine, posed new challenges for businesses and consumer alike.

In the first three months of 2022 GDP rose by 0.8 per cent – decent by historic standards, but a softer expansion than had been predicted as all pandemic-related restrictions were lifted. Looking at the sector contributions to growth at the start of this year, the three broad sectors – services, production, and construction – all posted expansion of the quarter. However, at a more granular sub-sector level it was something of a mixed picture.

Services output continued to rise for the fourth quarter running, by 0.4 per cent. However, this was the slowest pace of expansion for a year. Consumer facing sectors continued to recover, benefiting from the end of all Covid-19 restrictions in February, with accommodation and food activity rising by over five per cent compared with the previous quarter. Transport and storage also fared well on the back of a return to international travel. However, the main drag was from the health sector, in which the end of the 'track and trace' service contributed to a near two per cent quarter-on-quarter fall in output.

Manufacturing, which has had a bumpy ride over the past year – mostly a consequence of global supply chain disruptions – saw a solid increase of 1.3 per cent in output over the quarter. Nevertheless, the automotive sector – one of the industries at the sharp end of supply chain bottlenecks – continued to see output decline. In addition, the unwinding of Covid-19-related activity was also evident in manufacturing, with pharmaceuticals output falling backing sharply at the vaccine programme tails off. Finally, construction had a solid start to 2022 too, expanding 3.8 per cent with both new work and repair and maintenance posting solid growth.

While growth has slowed, price rises have moved sharply in the other direction. CPI inflation has been climbing since the global economy began emerging from Covid-19 and in April it hit a 40-year high of nine per cent. A substantial portion of the increase was from higher household costs, utilities, and fuel prices. Significant increases in international energy prices, as a result of the conflict in Ukraine have added to upward pressure on inflation.

These factors are also feeding through to higher costs for businesses. On the industrial side, manufacturers' input costs were almost a fifth higher in April 2022 compared with a year ago. Other industry segments are similarly exposed to these rises. The ONS Business Conditions and Insights Survey (BICS) shows that the two most commonly cited business concerns in recent months have been inflation in goods and services prices and energy costs. Some businesses are able to pass through some of these costs, but many are having to absorb them, which seems especially the case for those closest to the consumer.

The impact of higher inflation has been evident in rapidly weakening consumer sentiment since the start of this year. Households have become much more concerned about prospects for their finances over the next 12 months. Recent news that a further substantial increase in energy costs is likely in the autumn will do little to turn this around. Analysis has consistently pointed to households at the lower end of the income distribution spectrum facing the largest challenge from rising energy prices. Pressure has also been building on government to respond and the chancellor added to measures announced in the Spring Budget with a further £21 billion package to help households, mainly lower income ones, with rising costs.

While these are big numbers, it's yet to be seen whether this will alleviate households' concerns. It is unlikely to change the overall picture of a squeeze in real incomes this year and the likelihood of the economy contracting in at least one quarter later in the year. This is likely to mean more lingering uncertainty for businesses over the rest of this year. And with that the prospect of businesses unleashing an investment boom this year is also dissipating. Investment fell in the first quarter of this year and remains nine per cent below pre-pandemic levels. Near term, only around one in seven businesses are planning to increase investment spending, which is likely insufficient to drive a turnaround in the contribution of business investment to overall economy growth this year.

While the chancellor responded to calls to address pressure on household budgets, the Bank of England has responded to calls to ensure inflation doesn't race ahead of the Bank's target in the medium term by raising Bank Rate at every MPC meeting since December 2021. The decisions walk a tightrope between anchoring inflation expectations and not throwing the economy into reverse. CPI inflation could yet peak in Q4 this year, and with the chancellor using some fiscal firepower, the door remains very much open to more interest rate rises this year.

Overall, the forecast for the UK economy has deteriorated somewhat on the back of the factors discussed. The average forecast for GDP growth in 2022 has come down to 3.9 per cent and for inflation to average close to eight per cent. Currently forecasters remain optimistic about the labour market outlook, with only a modest rise in unemployment expected this year.

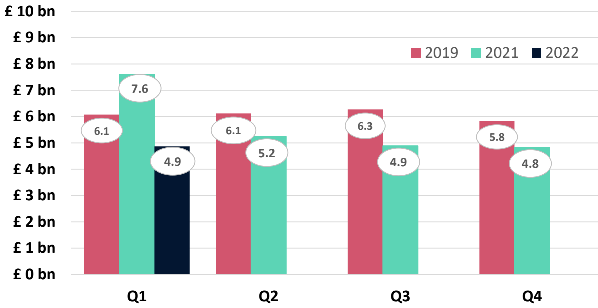
SME finance

While we are a year on from the end of the original government-backed loan support available to businesses to manage through the trading disruptions of the pandemic, it was only in the most recent quarter covered by our data that all remaining restrictions were lifted – allowing the full return of normal trading conditions for businesses.

Following the significant growth in lending volumes in 2020/21, demand for finance has been comparatively muted over the past year translating into a fairly stable picture on gross lending at around £5 billion per quarter ***(Chart 1)*** from the major high street banks covered in our sample. This is trending slightly below average quarterly gross lending reported in the two years prior to the pandemic.

As noted in the economic introduction, this trend is likely connected to the still muted plans for investment, though also important to note that the ONS survey indicates that business uncertainty is the main limiting factor, with only four per cent of businesses citing external finance as a factor holding back investment plans. This aligns with anecdotal feedback that banks' lending criteria remains unchanged.

Chart 1: Gross lending to SMEs through loans and overdrafts



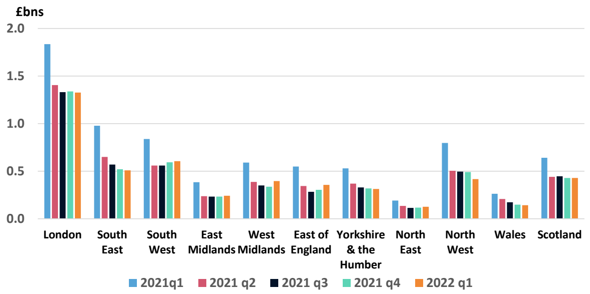
Source: UK Finance

One of the key messages in our Business Finance Reviews since the start of the Covid-19 pandemic has been the very consistent pattern of applications and lending across sectors and regions. While the challenges of the pandemic may have manifested themselves in different ways across sectors, virtually all businesses had to adapt to some extent to changes in demand or the way in which products and services were produced and delivered. This led to a uniform pattern of demand of finance, particularly in the context of the government's emergency support schemes.

Now that we see some sense of normality return, variation in demand across regions and sectors is re-emerging. ***Chart 2*** looks first at regional trends in gross lending.

All parts of Great Britain have seen lending fall back following the end of the government schemes, but in recent quarters some regions have posted signs of growth in new lending. In the first three months of this year, the West Midlands, East of England and the North East have seen the largest increase in gross lending. In contrast, the North West saw continued decline in lending flows. In other parts of the country the picture is one of broad continuing stability at the start of the 2022.

Chart 2: Gross lending by region



Source: UK Finance

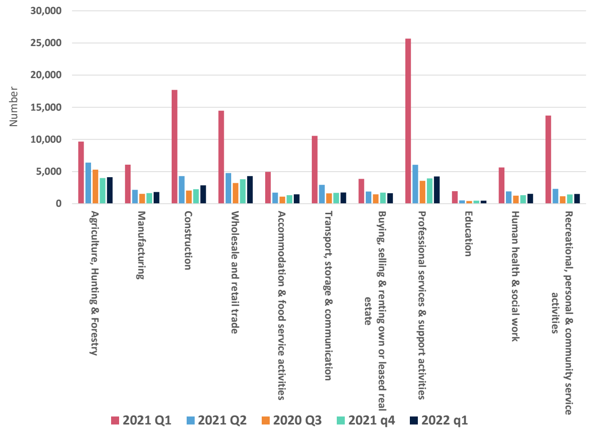
Movements in the demand for finance at the regional level are most likely underpinned by the sector mix rather than a function of geography. Higher than average concentration of manufacturing in the Midlands and North, and agriculture in the East of England – both of which are especially sensitive to movements in input costs and changes to trading arrangement – may explain part of the regional variation. Nevertheless, all GB regions mirror the national picture of gross lending hovering below pre-pandemic levels.

Our data also allows for analysis of the number and value of loans and overdrafts approved each quarter by sector. ***Chart 3*** illustrates approvals by volume. In line with the gross lending metric, the number of approvals has come down from previous pandemic highs – a consequence of lower application volumes. As can be seen in other data, such as the SME Finance Monitor, the proportion of applications that are approved has continued to run at around eight in ten over the past 12 months.

We have however seen some pick-up in the number of approvals in the past couple of quarters across some industries. In the first three months of 2022 notable increases were found in manufacturing, construction, wholesale and retail trade and accommodation and food services – all of which have seen the volume of approvals for two quarters running, from the low point of 2021 Q3.

Once again, and in line with the overall lending picture, applications and approvals remain down on that seen in the years before the pandemic.

Chart 3: Number of approved loans and overdrafts by sector

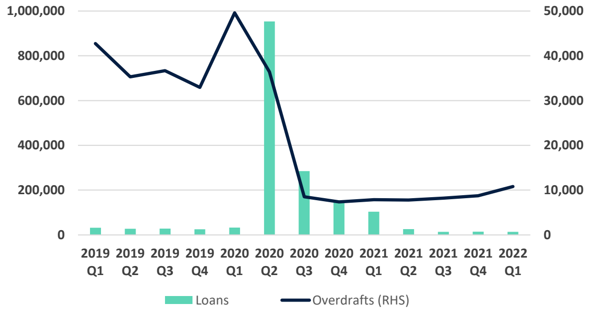


Source: UK Finance

A further change from the trends report in the Business Finance Review over the past few years is the mix of products SMEs are seeking to manage their finance and cashflow. Coming on the back of two years of very subdued demand for overdrafts, this quarter marks the first material increase in applications ***(Chart 4)***. As previously reported, requirement for new overdraft facilities collapsed following the introduction of government-back loans and has barely budged for much of the past two

years, with volumes trending significantly below pre-Covid-19 norms.
The most recent quarter has seen overdraft approvals rise by 23 per cent compared with the previous quarter. However, as the chart illustrates, this growth still leaves demand far below pre-pandemic trends. In contrast, there was little movement in loan demand.

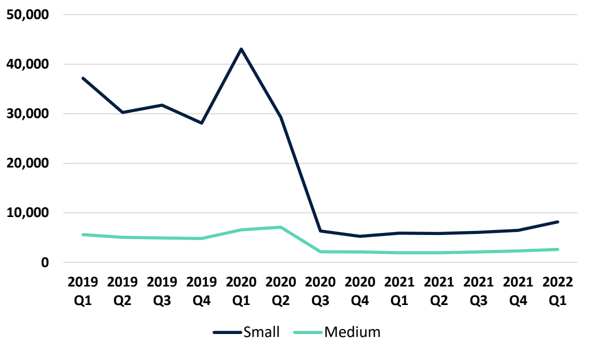
Chart 4: Number of approved loan and overdraft applications



Source: UK Finance

Digging further into the data we can see in ***Chart 5*** that much of this increase is concentrated amongst smaller SMEs, defined as businesses with a turnover below £2 million. Overdraft approvals amongst this cohort rose by 27 per cent quarter-on-quarter, to the highest level since 2020 Q2. That said, there was also an increased requirement for new overdraft facilities amongst medium-sized SMEs.

Chart 5: Number of approved overdraft applications by business size



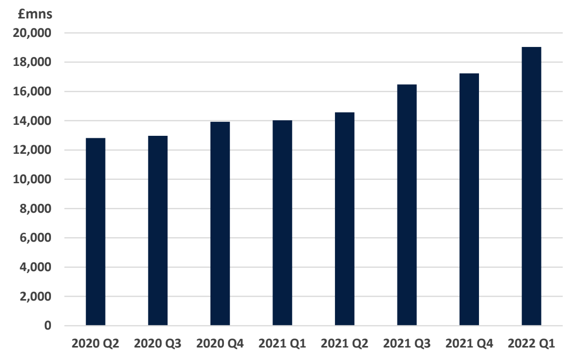
Source: UK Finance

This renewed demand is likely linked to the final removal of remaining social distancing restrictions and a return to normal trading. However, the recent surge in input costs which many businesses will be facing – a consequence of strong global demand, supply chain blockages and exacerbated by the Ukrainian conflict – may also be prompting SMEs to review their finance needs to meet working capital fluctuations.

Other forms of finance that support working capital include invoice finance and asset-based lending (IF/ABL). The fuller reopening of the economy and the consequent increase in business turnover means that businesses have more invoices against which finance can be secured. And as we have noted previously, to a certain extent the government loan schemes did impact demand for IF/ABL and other finance options provided on a commercial basis.

The end of government schemes, together with the rebound in activity, has spurred a solid rise in IF/ABL advances over the past four quarters. In the first quarter advances were reported at over £19 billion, ten per cent up on the previous quarter and close to the £21 billion of advances at the start of 2020.

Chart 6: Value of invoice Finance and Asset-based lending advances



Source: UK Finance

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

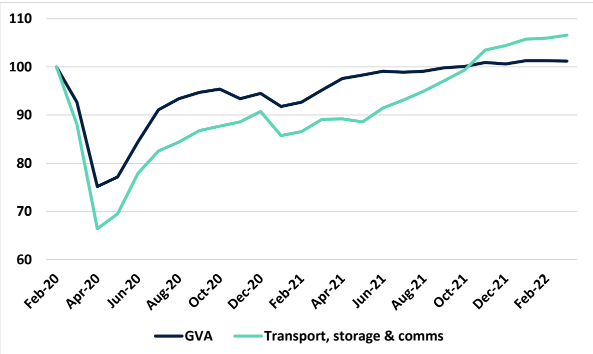
SPOTLIGHT: TRANSPORT, STORAGE & COMMUNICATION

Each quarter the BFR focuses on a particular region or sector. This quarter the spotlight is on the transport, storage, and communications sector.

The industry is comprised of land, air and water transport, warehousing, and courier services. Inevitably the impact of the Covid-19 pandemic was very uneven across the sub-sectors within this industry with transport activity contracting sharply, but with some compensation from growth in warehousing and courier services as households shifted spend online.

As a result, the path of contraction and recovery in the transport, storage and communications sector looks quite different from the economy overall, as shown in ***Chart 7.*** *While the restrictions on travel at the onset of the pandemic saw output fall more sharply during the early months of the pandemic, the sector responded to changing consumer habits and has subsequently seen a stronger rebound in activity.*

Chart 7: GVA index February 2020=100



Source: ONS

Output across the sector is now nearly seven per cent higher than in February 2020, compared with just one per cent across the wider economy.

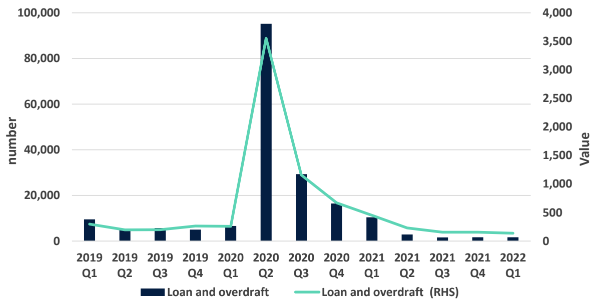
The mix of activity within the sector has, however, changed markedly during the pandemic. Air and water transport previously accounted for 16 per cent of output and now accounts for nine per cent and courier services has increased its output share from 15 per cent to 20 per cent over the same period.

While growth in the sector has been firm in recent quarters, the outlook is not without its challenges. The ONS Business Conditions and Insights survey notes that, like many other sectors, transport and storage businesses are struggling to recruit and are more concerned about the impact of rising energy prices.

Turning now to recent finance trends across the sector, ***Chart 8*** *illustrates the evolution of loan and overdraft approvals over the past three years. Finance approved for transport and storage SMEs has moved in line with that seen in the wider economy, with approvals spiking following the introduction of government-backed loan schemes and dropping off through 2021.*

Indeed, data from the British Business Bank show that the volume of CBILS and BBLS loans was in line with the sector share of total businesses. Approvals, notably loans, have been a bit stronger in this sector over the past two quarters, increasing by around four per cent quarter-on-quarter in the past six months, in line with the recovery in activity. In contrast, overdraft approvals have continued to trend down over the same period.

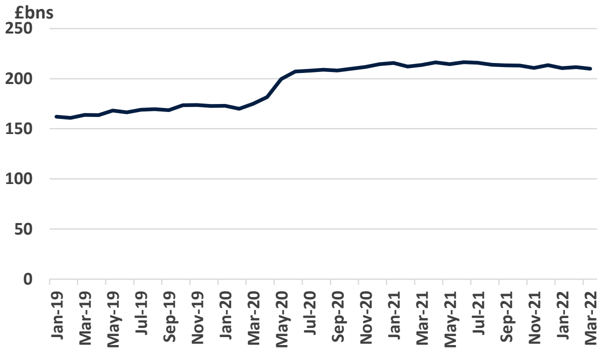
Chart 8: Loan and overdraft approvals,



Source: UK Finance

Deposits across the sector have followed broadly the same path as that seen in the rest of the economy – a significant increase in Q2 2020 then largely stable thereafter ***(Chart 9)****. In the most recent quarter, the value of* *deposits has decreased slightly by just over 1.5 per cent. Nevertheless, SMEs in the sector have an additional £3.5 billion of deposits compared with two years ago.*

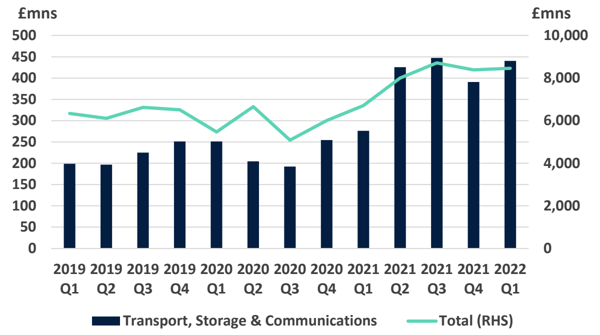
Chart 9: SME Deposits



Source: UK Finance

The other side of the expansion in lending via the government loan schemes is the start of scheduled repayments. In line with the rest of the economy C***hart 10*** *shows a marked rise in repayments as these fell due a year ago across the transport and storage sector. And this elevated level of repayments compared with previous trends has been sustained in subsequent quarters. In the most recent three months period, repayments were up nearly 13 percent on 2021 Q4.*

Chart 10: Repayments



Source: UK Finance

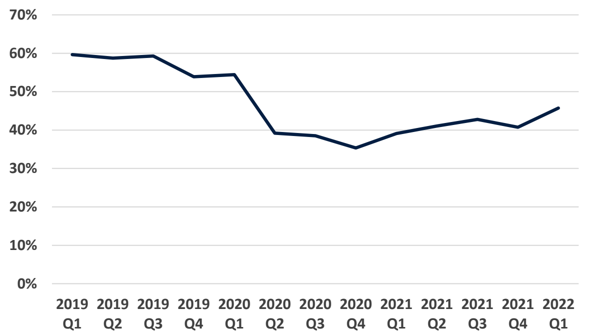
Financial headroom

Across the remaining metrics in our report the story continues to be one of a gradual return to normal, but ahead of potentially more challenging economic times ahead SMEs still appear to have a reasonable cushion in their existing finance arrangements.

In addition to the emerging recovery in demand for new overdraft facilities, SMEs are also starting to make greater use of existing arrangements ***(Chart 11)***. Overdraft utilisation has been creeping up through 2021 but showed a more marked rise at the start of this year. The utilisation rate stood at 45 per cent on average in Q1, up from the low of 39 per cent in the second half of 2020, but still below 2019 rates. As noted above, advances provided through IF/ABL facilities also increased although there remains significant headroom in those facilities overall.

Increased overdraft utilisation was evident across most industry sectors and the increased usage was greater than average in manufacturing, construction and accommodation and food service activities. However, common across all industries is that utilisation rates still have some way to catch pre-pandemic rates, offering businesses across the economy continued headroom within arranged facilities.

Chart 11: Overdraft utilisation, percentage

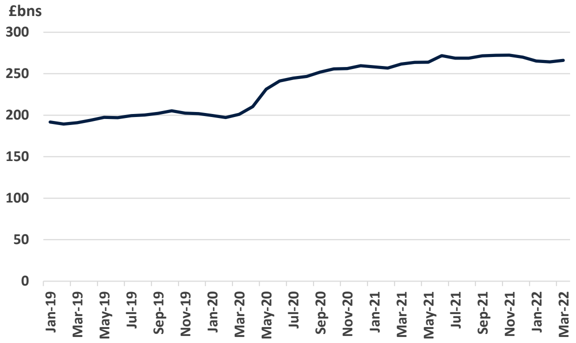


Source: UK Finance

As expected, growth in deposits held by SMEs would inevitably end as business activity picked up post-Covid-19. We have seen deposits slowly drift down in the autumn last year and in Q1 we saw a further, albeit still modest decline of around one per cent.

Nevertheless, SMEs continue to have access to significant accumulated deposits ***(Chart 12)*** with the overall value standing some £69 billion or 35 per cent higher when compared with February 2020. We note slightly less sector variation in the change of deposits compared with some other metrics. However, the quarter-on-quarter decline was slightly larger than average (at over five percent) in wholesale and retail trade and accommodation and food service activities.

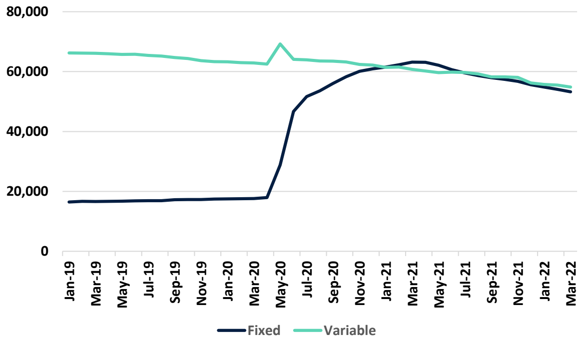
Chart 12: SME Deposits



Source: UK Finance

On the personal finance side, there is increasing attention on the decisions of the Monetary Policy Committee and how recent interest rate rises will impact on households, particularly mortgage holders. SMEs are not shielded from rising Bank Rate, but growth in lending supported by government-backed schemes brought about a material change in the balance of outstanding SME loans on fixed and variable interest rates. Bounceback loans, which accounted for the lion's share of SME pandemic lending, were provided at a fixed 2.5 per cent interest rate. While this stock has been declining ***(Chart 13)*** as SMEs have started repayments, around half of lending will be unaffected by recent or future changes to Bank Rate.

Chart 13: Value of stock of lending on fixed and variable interest rates



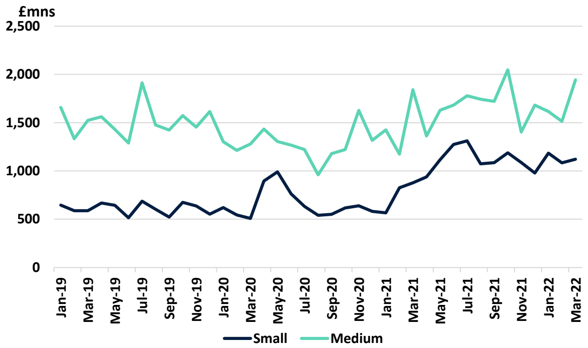
Source: UK Finance

Repayments

Finally, repayments continue as SME continue to meet obligations to repay government scheme lending apace in the final months of 2021 as shown in ***Chart 14.*** The profile of repayments will be impacted when the interest-free repayment holiday expires, including the opportunity to extend this with a Pay-as-you-grow option. The surge in repayments mid-2021 reflects some companies repaying their BBLS or CBILS loan in full when repayments fell due. Since then, the trend in repayments has been broadly stable, including in the most recent quarter when they rose by one per cent compared with 2021 Q4.

Repayments by small companies (sub-£2 million turnover) looks to have been more consistent since mid-2021, with a bit more volatility in repayment trends amongst medium-sized businesses, including a jump in repayments at the end of Q1. This represents a reasonably positive position for SMEs ability to meet repayments of Covid-19

Chart 14: Value of repayments by business size



Source: UK Finance

Outlook for SME finance

Our latest Business Finance Review shows a continuation of the gradual return to normal lending trends across SMEs. The modest uptick in demand for finance to manage cashflow with overdrafts and invoice finance and asset-based lending is a consequence of both the end of Covid-19 restrictions and the significant increase in cost pressures that many businesses are now facing.

The steady flow of repayments of government-backed lending is encouraging in that SMEs are able to meet this obligations and feedback suggests that, while there are some businesses falling behind, payment problems are not yet, at least, as prominent as many had initially feared.

That said, the outlook for the economy is becoming more challenging. Inflationary pressures are sapping consumer confidence and the prospects for demand are looking much weaker towards the back end of this year than forecasters were expecting just a few months ago. As a result, many businesses are rethinking investment plans. If a rebound in investment spending does not materialise this year, that will likely dampen demand for new finance to support projects. It is the demand outlook, rather than concerns about access to finance that is weighing on capex plans, as reported in the ONS Business Conditions and Insights survey.