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 the first half of 2022 as 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:

"New lending to SMEs remained stable in the first half of this year but looking ahead there are signs of a slight reduction in demand for finance. Increased costs, including rising energy prices, means businesses have been cautious about committing to longer-term investments. However, these concerns should be helped by the energy price guarantee that will apply to businesses.

"In the meantime, the availability of finance remains consistent and repayments continue steadily to reduce total outstanding borrowings from their peaks last year. SMEs appear to be focused on managing cashflow challenges, with overdraft demand stable and invoice finance advances rising significantly over the past year as more clients are starting to use this form of finance again.

"As has been the case over the past year, there remains a high degree of financial headroom across SMEs, and lenders continue to stand ready to support businesses."

2022 Q2 HIGHLIGHTS

- **Gross lending to SMEs edged higher to £5.1 billion in Q2.**
- **Following a material increase in overdraft applications and approvals in Q1, demand for new facilities held firm in Q2.**
- **Overdraft utilisation also increased for the second quarter running.**
- **Invoice Finance/Asset-based lending (IF/ABL) advances continue to rise and client numbers also grew.**
- **New loan applications and approvals fell back on the quarter.**
- **Repayments held steady and above pre-pandemic levels.**
- **The level of SME deposits was stable in the quarter and lower than the same time a year ago.**

Economic outlook

The economic context to this Business Finance Review continues to be challenging and arguably more so than three months ago. Overall growth in the UK economy faltered in the second quarter of 2022 with GDP posting a modest 0.1 per cent contraction. But, as we have seen since the end of Covid-19 restrictions, there was a large degree of sector variability underneath the headline number.

In Q2, services were the dominant drag on growth, with output falling 0.4 per cent quarter-on-quarter. While consumer-facing segments continued their post-pandemic bounceback, with notable strong activity in travel and tourism, the wind down in Covid-19 related health activities continued to weigh on the service sector overall.

More positively in the quarter, production output rose with growth largely coming from gas and power generation, but manufacturing activity was broadly flat. Construction was a bright spot again in Q2, as increase in new work, and repair and maintenance underpinned a 2.3 per cent rise in output.

A somewhat unexpected development over the second quarter was a rise in business investment. After something of a rebound in Q2 last year, investment growth has been stagnant – quashing hopes that an investment revival might provide a fillip to growth. In the latest quarter, business investment rose by near four per cent, supported mainly by new buildings, but with other asset classes also seeing growth.

However, the cloud of rising input costs remained. In the year to July producer input prices were nearly 23 per cent higher compared with a year ago, only fractionally down on the series highs reported in June. Consequently, factory gate price inflation ticked up to just over 17 per cent – another series high. Survey indicators for the service sector point to similar trends with the S&P Global/CIPS UK Services PMI pointing to operating expenses and prices charged rising at elevated rates in Q2 and into the summer.

Growing concern about energy prices, in particular, was evident in the ONS's fortnightly business survey (BICS). Between March and September, the proportion of businesses citing energy prices as a concern has risen from 15 per cent to 22 per cent, with businesses in hospitality and manufacturing sectors more likely to be worried about the impact of rising energy bills. Businesses were not captured by the previous price cap which was operating from April and there were anecdotal reports of businesses coming to the end of fixed contracts potentially facing the prospect of double or even triple-digit increases in energy bills. The recent announcement from the new government of a lower price cap for households than that announced by Ofgem in August, with a similar pricing mechanism for businesses, should alleviate some business concern over the winter.

Despite some of the challenges that lie ahead labour market conditions remain tight, with unemployment edging down to 3.6 per cent and vacancy rates remaining close to record highs. However, vacancies appear to have come off the boil with numbers dropping in the three months to August for the first time since August 2020. There may be further falls ahead, as the latest manufacturing PMI (August 2022) indicates that job growth across the sector has stalled. Wage growth, while continuing to lag inflation, was still increasing at over five per cent in the three months to June.

The expectation amongst forecasters is that the economy is facing some significant headwinds from high inflation and cost-of-living pressures in the coming quarters. While the Bank of England now expects the inflation peak to be slightly lower as a result of the government's new energy price cap, it is expected to continue raising Bank Rate into 2023. The government's 'mini-Budget' announced significant fiscal loosening in the coming years through tax cuts for both businesses and households, including the decision not to proceed with the planned rise on corporation tax, the much-trailed reversal of the national insurance rise for individuals and businesses and planned cuts to the basic and top rate of income tax from next year.

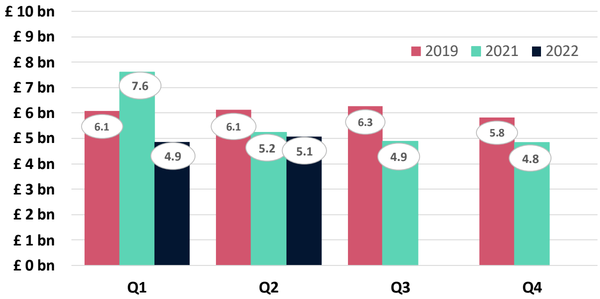
The reaction following the announcement was significant, prompting a sharp fall in Sterling and rising gilt yields. Markets also priced in a much more aggressive pace of monetary tightening from the Bank of England. Difficult decisions for policy makers lie ahead with both the growth and inflation outlook remaining highly uncertain – an outlook which is likely to continue to challenge businesses.

SME finance

Gross lending, as reported by the Business Finance Taskforce Banks, in the UK rose slightly in the second quarter of 2022 to £5.1 billion. This was the highest quarterly value of lending since the same time a year ago, but nevertheless continues a largely stable trend in lending since the end of the government-backed loans that were in operation during the pandemic. Over the past year, the post-Covid-19 stabilisation of new lending remains slightly lower than the average seen in 2018 and 2019.

(Chart 1)

Chart 1: Gross lending to SMEs through loans and overdrafts



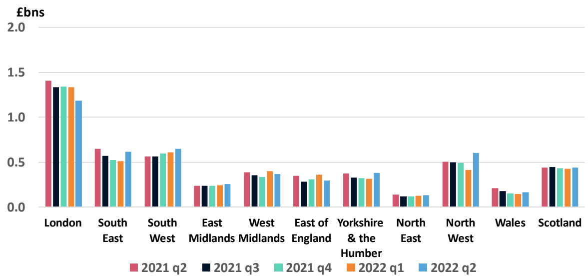
Source: UK Finance

As we noted last quarter, this post-Covid-19 return to more normal lending trends has led to some regional divergence in lending. Through much of 2020 and 2021, government-backed loans were distributed fairly evenly across all parts of the UK as all regions and industries faced similarly challenging trading conditions resulting from the pandemic.

However, so far this year we have seen more variable lending patterns across the country – a likely consequence of a multi-speed recovery for different sectors in the first half of this year and emerging cashflow challenges, such as rising input costs.

In the three months to June, there were notable increases in gross lending to SMEs in the North West and the South East of England. In contrast, gross lending to SMEs in the East of England and London fell back compared with the previous quarter. However, in line with the national picture lending across all regions continues to trend slightly lower than pre-pandemic averages.

Chart 2: Gross lending by region



Source: UK Finance

Despite the modest uplift in lending in the most recent quarter, new applications for finance, particularly new loans softened. Overdraft applications held broadly stable following a solid increase in the first quarter of this year. Consequently the number of approved loans and overdrafts followed a similar pattern with the approval rate holding steady in recent quarters.

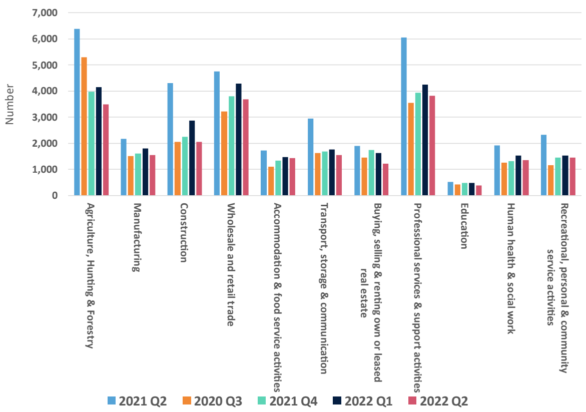
The divergence in trends between loans and overdraft applications, which emerged last quarter and become somewhat more pronounced in the most recent period, may be a reflection of the need to manage cashflow in the face of substantial rises in many input costs, particularly in sectors such as manufacturing, construction and hospitality.

This increase in demand for working capital facilities - also demonstrated by the increases in advances seen under invoice finance and asset-based lending facilities, see below - is supported by recent findings from the SME Finance Monitor which indicates that the primary motivation for applying for finance has been cashflow management rather than business development.

On the weaker loan demand, this is potentially a response to rising economic uncertainty. With forecasters pointing to the potential for the UK to enter recession at some point this year, driven by the squeeze on household incomes and likely reduction in overall demand, businesses may have become more cautious about the investment climate. The likelihood of further increases in Bank Rate may also be a factor in SMEs pausing borrowing and lending plans.

These factors appear to be playing out fairly consistently across different industry sectors, as shown in ***chart 3***. After ticking up across most sectors last quarter, approvals for new facilities went into reverse in the three months to June. While loan and overdraft approvals to firms in accommodation and food services and recreation and personal services held steady in Q2, in other sectors there was a decline relative to Q1. Particularly notable was the drop in applications and approvals in construction and agriculture.

Chart 3: Number of approved loans and overdrafts by sector



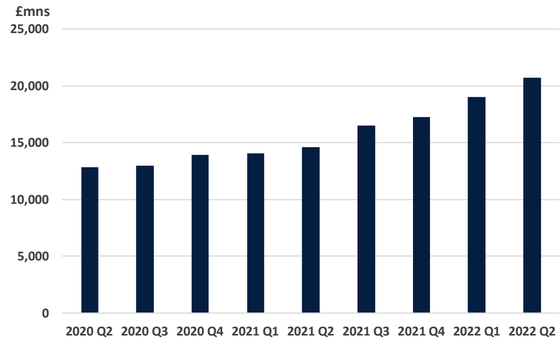
Source: UK Finance

As noted above, increased demand for finance to support cashflow and working capital is also being met by increased usage of invoice finance and asset-based lending (IF/ABL). These forms of finance have seen more material growth post-pandemic, during which there was a clear substitution for government-backed lending solutions.

The most recent quarter has seen further growth in IF/ABL advances, with quarterly totals now broadly back to pre-pandemic levels. The number of businesses using IF/ABL over the quarter rose modestly, to stand at the highest number since 2021 Q1. New client growth was strongest amongst firms securing stock finance and asset-based lending. The growth in the total sales of clients supported by invoice finance and asset-based lending has been notable also; the members of UK Finance's IF/ABL stream supported total client turnover of £75.3 billion during Q1, the second highest quarterly level ever. This is up over 11 per cent on 2021 Q1. Taken in context with the GDP data for the same period, this further underlines the importance of these products in supporting businesses throughout the economic cycle.

IF/ABL advances rose on the quarter (***chart*** 4and year-on-year to firms in all reporting size bands, but annual growth was particularly strong amongst larger businesses with a turnover of over £10 million. There are some sector differences evident in the past year, with growth in advances strongest in retail.

Chart 4: Value of invoice Finance and Asset-based lending advances



Source: UK Finance

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

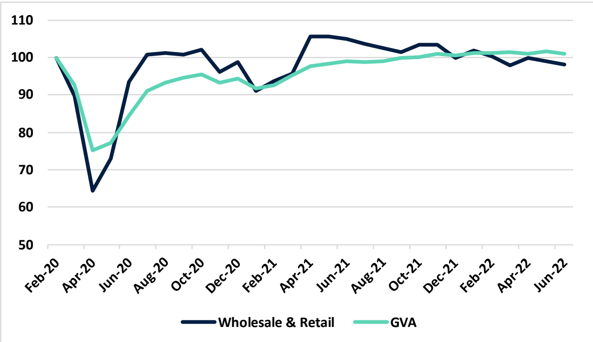
SPOTLIGHT: WHOLESALE AND RETAIL TRADE

Each quarter the BFR focuses on a particular region or sector. This quarter the spotlight is on the wholesale and retail trade sector.

*The wholesale and retail trade sector comprises sale and repair of vehicles, wholesale trade and retail activities. Like all sectors, the wholesale and retail trade industry took a significant hit with the introduction of Covid-19 restrictions in 2020, but the downturn was sharper but shorter than that recorded for the economy as a whole (**chart 5**). Following the initial rebound in output in mid-2020, the sector has seen a significant volatility in trading conditions which has resulted in output currently below pre-pandemic levels.*

There have been particular challenges for the sale and repair of vehicles, which has been exposed to supply chain disruptions and materials shortages. And despite some modest growth in the most recent quarter, output in this subsector is nearly eight per cent below pre-Covid-19 levels. Other wholesale and retail trade has also seen output decline over the past year.

Chart 5: GVA index February 2020=100



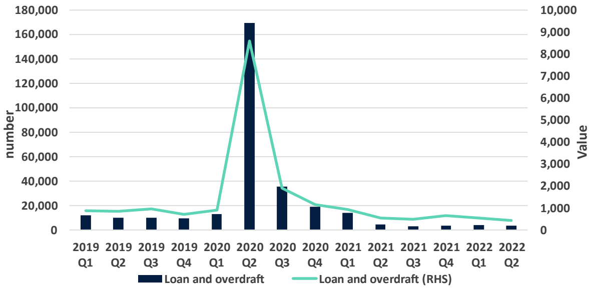
Source: ONS

According to the ONS BICs survey, businesses in the sector continue to be hampered by global supply chain issues, with respondents attributing these to a combination of increased costs, material shortages and Brexit. In the same survey the sector's growth expectations for the next 12 months are more downbeat than the economy average, with 59 per cent of firms predicting that their business performance will be the same or better compared with 70 per cent across all industries.

*Turning now to recent finance trends across the sector, **chart 6** illustrates the evolution of demand for finance in recent years. In line with the broader trend across the economy, applications and approvals for loans and overdrafts spiked during the pandemic and have subsequently settled at levels lower than in 2019.*

However, breaking down the approvals, there has been a greater appetite for new overdraft facilities, particularly in the past three quarters although this still remains below pre-Covid-19 levels of demand. This is likely linked to concerns about increasing cost pressures across parts of the sector.

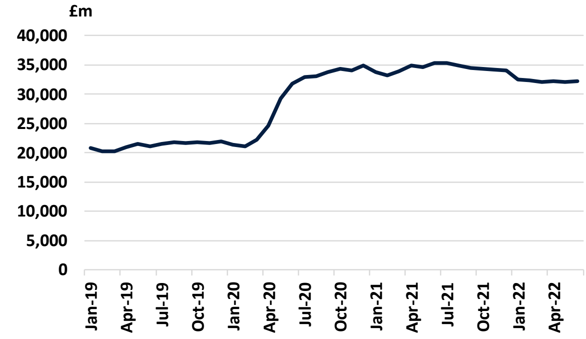
Chart 6: Loan and overdraft approvals



Source: UK Finance

Chart 7 shows the accumulation of deposits in the wholesale and retail trade sector during the pandemic period. While the growth in savings during 2020/21 mirrored that seen in the rest of the SME sector, the recent fall back has been more marked. The value of deposits at the end of Q2 was some nine per cent lower than the same period a year ago, with the sector reporting the bulk of this reduction in the first quarter of this year. This coincides with the full opening of the economy after Covid-19, which will likely have prompted requirement for additional restocking, but also the conflict in Ukraine which has led to significant increases across a range of goods and services.

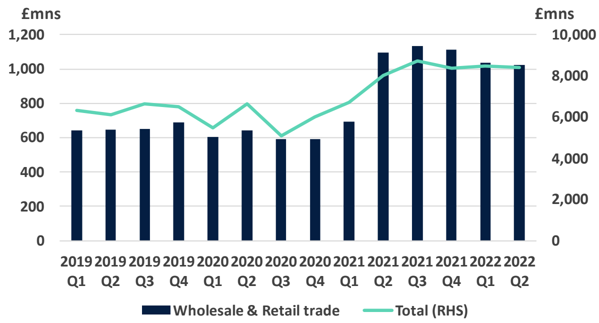
Chart 7: SME Deposits



Source: UK Finance

*Finally, the wholesale and retail sector is following the same repayment behaviour as that seen in the rest of the economy. With the spike in loan approvals in 2020 – a result of firms in this sector utilising government-backed loans – and the repayment obligations kicking in in mid-2021, **chart 8** illustrated the sharp rise in repayment values in mid-2021 which has been sustained in subsequent quarters, including the most recent one.*

Chart 8: Repayments



Source: UK Finance

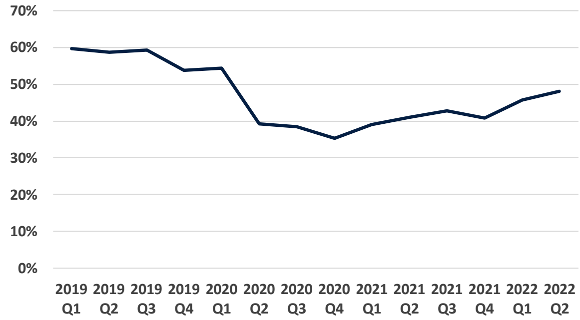
Firms in the sector retain a relatively high degree of confidence that they will continue to meet their debt obligation, as reported in the regular ONS BICS survey. Of those with some borrowing, around three quarters are moderately or very confident that they will be able to manage repayments, in line with the average across all businesses.

Financial headroom

While we have seen some softening demand for new finance over the quarter, our data continues to show a relatively high degree of flexibility within existing arrangements, at the aggregate level for SMEs.

Firstly, ***chart 9*** shows that while overdraft utilisation has edged higher again over Q2, usage rates are still lower than reported pre-pandemic and SMEs therefore retain a large degree of headroom within arranged overdraft facilities.

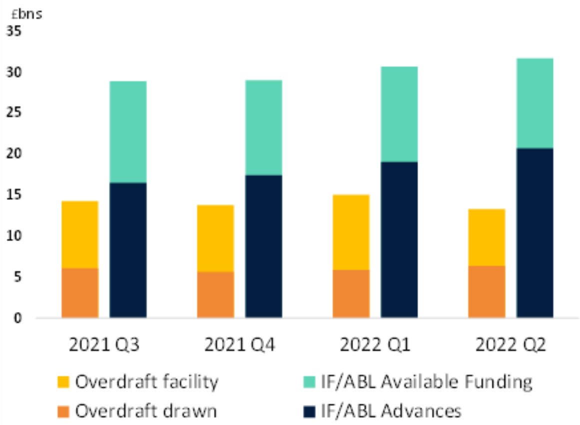
Chart 9: Overdraft utilisation, percentage



Source: UK Finance

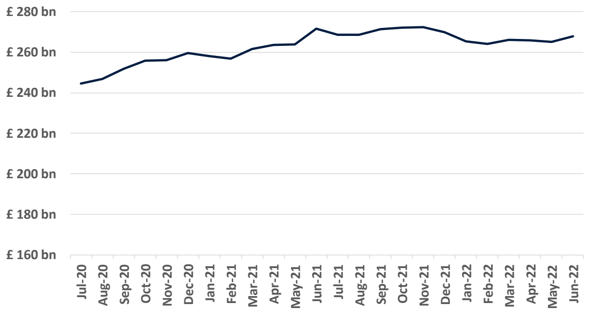
The same holds for available funding within invoice finance and asset-based lending facilities. ***Chart 10*** shows the increase in advances in Q2, of which over a third are unutilised.

Chart 9: Available overdraft and IF/ABL funding



Source: UK Finance

Chart 11: SME Deposits



Source: UK Finance

The final element of available headroom is cash deposits (***chart 11***). A downward trend in total deposits was evident at the end of 2021, since then, while there has been some month-to-month volatility, the trend has been stable.

Compared with a year ago the value of total deposits has dropped by 1.5 per cent, although a larger fall was seen in the value of time deposits, which are down five per cent year-on-year. However, current values continue to represent a significantly larger cash cushion than was available prior to the pandemic. Our data also chimes with survey data from the SME Finance Monitor, which continues to show that the proportion of SMEs holding more than £10,000 in credit balances is sustained at higher levels than seen before the pandemic.

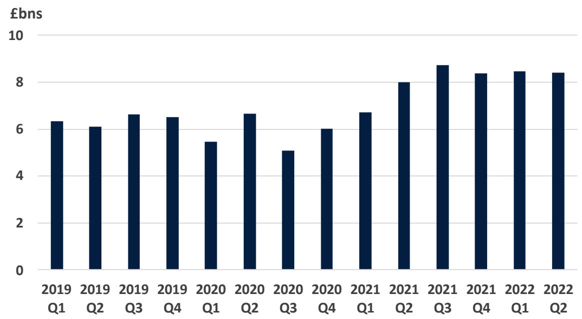
Repayments

The value of repayments by SMEs has been stable at around £8.4 billion for the past three quarters, including in the most recent period (***chart 12***). Repayment trends across small- and medium-size businesses continue to move in tandem and the data shows a corresponding reduction in loan stocks from the peak last year.

Data recently published by the Department for Business on the performance of government-backed Bounceback loans supports the continuing trend in elevated repayments by SMEs. Analysis of British Business Bank data shows that more than seven in ten BBLS loans are currently up to date with repayments or have been fully repaid.

Looking ahead, survey evidence from both the ONS Business Insights survey and the SME Finance Monitor continue to point to relatively firm levels of confidence that businesses can continue to meet their repayment obligations. In the ONS survey, over three-quarters of businesses with some borrowing report to be very or moderately confident about managing repayments.

Chart 12: Value of repayments



Source: UK Finance

Outlook for SME finance

In the first half of this year, it's been 'steady as she goes' for SME borrowing and repayments. While we are seeing the re-emergence of some regional and sector variation in the demand for finance, the story is one of demand tilted towards cashflow management but understandable caution about the future.

The demand outlook once again appears to be uncertain for businesses as demand from consumers is likely to be weaker as households manage cost-of-living pressures, and the global implications of the continuing war in Ukraine continue to present cost and supply chain challenges.

The government's recent announcement of support for businesses in managing rising energy costs will provide some welcome breathing space over the winter. However, we expect the appetite for finance for new investment and business development opportunities to be subdued in the coming quarters – a least until some of the clouds of uncertainty have started to clear.

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