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 against the backdrop of a slowing economy and an uncertain year ahead.

Stephen Pegge, Managing Director of Commercial Finance, comments:

"2022 was a year of two halves. Demand for loan finance from SMEs had stabilised following the end of the government loan schemes and repayments beginning to fall due, but there was a growing need for products to manage cashflow in an environment of sharply rising costs.

"However, as the year progressed with more uncertainty about the economic outlook and rising interest rates, SMEs were more cautious, further depressing their appetite for finance and investment, with similar trends playing out across all regions and sectors.

"Our data does show the profile of repayment holding steady suggesting that despite the headwinds of 2022, the majority of SMEs continue to show resilience and are managing their Covid-19 debt obligations. We continue to encourage any business concerned about sustaining this to have an early conversation with their lender.

"If, as expected, the economic gloom starts to lift later in the year, we should see confidence return and investment plans come back on stream with an associated pick up in demand for finance to support this. In the meantime, lenders will maintain their support for businesses managing cashflow needs."

2022 Q4 HIGHLIGHTS

- **Gross lending by the main high street banks totalled £18.4 billion in 2022.**
- **Loan applications and new lending slowed in the second half of the year.**
- **Overdraft applications and utilisation were higher compared with 2021.**
- **IF/ABL advances edge down in Q4 following nine quarters of growth.**
- **Across both overdrafts and IF/ABL businesses continue to have access to funding in existing working capital facilities.**
- **Repayments edged down over the course of the year but remained above pre-pandemic levels in 2022.**
- **SMEs started drawing on accumulated cash with deposits declining five per cent, year-on-year.**

Economic outlook

The UK economy expanded by four per cent in 2022. Underneath this buoyant headline number is the reality that output only increased in the first two quarters of the year. Performance can best be described as stagnant in the second half of 2022 with the economy just about escaping recession.

The UK, and global economy, has had to deal with headwinds from overlapping shocks – post-Covid-19 supply chain disruptions and the invasion of Ukraine – which prompted a sharp rise in global inflation, bearing down on consumer spending power. Central banks had to move quickly to wrestle inflation down and contain inflation expectations, which applied further brakes to demand.

Looking at a sector breakdown of growth across last year, services expanded by 5.5 per cent, but output remains below pre-pandemic levels. It was a good year for professional, scientific, and support services, accommodation and food, and transport, storage, and communications, all of which have recovered output lost during Covid-19. In line with the wider economy, most of the strength in these sectors was recorded in the early part of the year, trailing off in the latter part of 2022. The effects of industrial action also contributed to weakness across part of the service sector in the autumn.

2022 was also a relatively good year for construction, which has seen steady growth in the post-Covid-19 period and expanded by 5.6 per cent last year. The mix of growth, however, has shifted from growth in new orders related to housing and repair and maintenance to new infrastructure projects.

The news was less positive from production sectors. Manufacturing contracted by nearly five per cent last year after a decent 2021 with energy costs and stuttering global demand leading to activity declining in every quarter in 2022. Shrinking output was broad based in with a handful of exceptions in the latter part of the year, namely transport equipment and pharmaceuticals.

The big numbers last year were in relation to price rises. CPI inflation nudged past 11 per cent in October with energy price rises, escalating food costs and rising inflation in the service sector combining to push CPI to a 40-year high.

While these factors are weighing on households, curtailing spend on non-essentials, they continue to be a significant source of concern for businesses. The latest ONS BICs survey for January 2023 shows that nearly two-fifths of business saw higher prices for goods and services purchased compared with the previous month. On a somewhat more positive note, these inflationary pressures on business do appear to be easing with surveys such as the purchasing managers' indices indicating that upward pressure on costs and prices may now be past their peak.

In response to a more challenging demand outlook hiring has slowed. The number of vacancies across the economy peaked in the three months to May and have been steadily declining but remain above levels seen in 2019 indicating continued tightness in the labour market. This also pushing up pay settlements, adding to business costs as they seek to retain staff and respond to household cost of living pressures.

There was a further upside surprise in recent data with a stronger profile for business investment than previously thought. Investment by businesses rose by ten per cent in 2022 and is now within touching distance of pre-Covid-19 levels. Some revisions to past data by the ONS was attributed to the inclusion of some big-ticket investments, perhaps suggesting that the strength in investment is down to larger firms, rather than the SMEs covered in our Review.

The Bank or England's interest rate setters have continued to raise Bank Rate at its meetings so far this year in response to high inflation, a tight labour market, and more resilience in the economy. Bank Rate now stands at four per cent. The MPC is keeping a close eye on labour market developments, stickier services inflation and inflation expectations. However, forecasters think we may be close to the top of the cycle, which will likely be some way below that predicted last November.

Indeed, the OBR's latest forecast update is factoring in just one more quarter point rise this year. In addition, it now thinks the UK will avoid a technical recession, though with weak growth leading to a full-year GDP contraction of 0.2 per cent. While inflation is expected to continue to fall, pressure on household incomes this year is notable in the revised forecast.

With growth looking slightly better and the costs of some autumn statement measures, notably the energy price guarantee, coming in lower than expected, the chancellor had some room to increase spending in priority areas. Key measures pertinent to the SME community included full expensing of capital investment for three years (and a noted desire to make this permanent), a suite of measures to tackle economic inactivity – changes to pensions taxation and support for childcare, //and extending the 5p cut to fuel duty. Households will also see the £2,500 energy price cap remain in place until July.

SME finance - 2022

2022 was a year of two halves, not just for the performance of the economy, but also the path of SME borrowing. The total tally for gross lending to SMEs by the main high street banks was £18.4 billion in 2022. This was almost a fifth lower (18 per cent) compared with 2021 – when lending through government-backed loans was in operation for at least part of the year – and below the norms of the years before the pandemic (***Table 1***).

In part, this is a consequence of rising economic uncertainty, but also the diminishing share of total lending to SMEs accounted for by the main high streets banks. Increased competition in the SME lending market has seen specialist and challenger banks accounting for an increasing share of SME lending.

Table 1: Annual SME finance comparisons

		2020	2021	2022	% change 2021-2022
Lending					
Grross Lending	*£mns*	63,561	22,568	18,419	-18%
Net Lending	*£mns*	40,352	-9,245	-12,843	39%
Loan application	*No*	1,791,989	237,267	62,679	-74%
Overdraft application	*No*	135,480	45,443	55,343	22%
Overdraft utilisation		35%	41%	44%	
Repayments					
Total Repayments	*£mns*	23,209	31,814	31,262	-2%
Deposits					
Sight	*£mns*	158,206	166,500	159,257	-4%
Time	*£mns*	101,394	103,505	99,194	-4%

Source: UK Finance

However, three-fifths of total lending in the year took place in the first six months, with the quarterly profile of borrowing showing a marked slow down in the autumn. This aligns with sharply rising costs, heightened uncertainty about the economic outlook and the risk of recession, and a rising interest rate environment.

Taken together, this weighed on survey indicators of investment appetite, such as those reported by the British Chambers of Commerce, and a reduced appetite for additional finance – as seen in the lower number of small businesses planning to apply for finance in the SME Finance Monitor. Throughout 2022 the SME Finance Monitor has shown that the proportion of SMEs planning to apply for finance has trended down and remains notably lower than recorded in the years before the pandemic – a trend seen across SMEs, with employees, of all sizes.

In contrast, as we have shown in our Reviews over the course of last year, there has been a gradually increasing demand for working capital, such as overdrafts. The number of overdraft applications rose by 22 per cent in 2022 compared with the previous year, however, application volumes, again, trended below pre-Covid-19 levels. Growth in both

applications and utilisation rates are likely a response to managing rising input and energy costs, which have been rising rapidly across almost all sectors over the past 12 months.

SMEs have also started to draw on deposits accumulated through the pandemic. Both sight and time deposits ended the year some four per cent lower than the same period in 2021. Nevertheless, overall SMEs continue to have more cash at their disposal than was in the case before the pandemic.

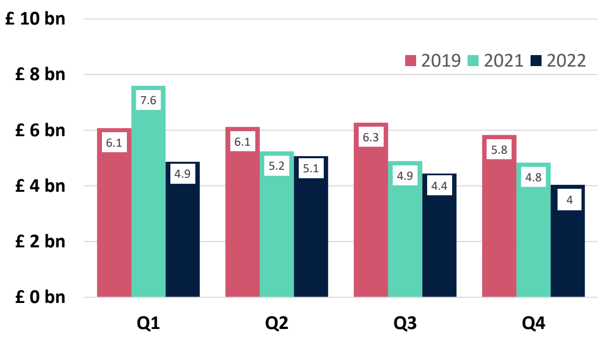
Finally, repayments continued to be elevated as businesses continue to pay down the government backed loans taken out during the pandemic. While the value of repayments was slightly down on 2021, this is a consequence of the profile of BBLS and CBILS repayments falling due. Some SMEs, who had accessed government backed lending as a precautionary measure during the pandemic opted to fully repay the loans when the 12-month interest free period concluded in 2021. It appears that this trend of full repayment has slowed somewhat.

2022 Q4 developments

As noted above, our data from the main high street banks points to a notable slowdown in borrowing activity in the second half of the year and this was evident in the final three months of 2022.

Gross lending ***(Chart 1)*** fell back to £4 billion, down from £4.4 billion in the previous quarter. In addition to the headwinds to SME activity that were evident throughout much of 2022, demand for finance in Q4 may also have been depressed by financial market turmoil last autumn, the prospect of more significant increases in Bank Rate, and forecasts of a more significant downturn in the UK economy. It should be noted, however, data from the challenger and specialist banks (reported by the British Business Bank and Bank of England) indicates a more complex story, with gross lending from those institutions ticking up

Chart 1: Gross lending to SMEs

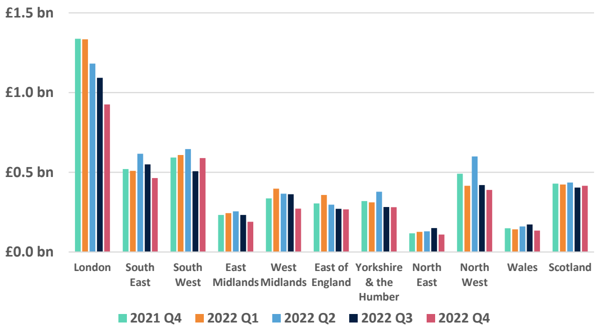


Source: UK Finance

These factors appeared to weigh on businesses in almost all regions of Great Britain as shown in ***Chart 2***. The largest declines in gross lending at the end of 2022 were seen in Wales, the North East and the West Midlands. It is worth noting that the drop in lending to SMEs in the West Midlands in the final three months of the year follows a period of relative stability in gross lending compared with other regions in the first three quarters of 2022.

Two regions, however, bucked the weakening trend – The South West and Scotland seeing increases of 16 per cent and three per cent, quarter-on-quarter, respectively. In the South West there may be some rebound effects, following a particularly weak Q3. However, the modest rise in Scotland is consistent with a more stable path of lending in the region since the end of the government-backed loan schemes in 2021.

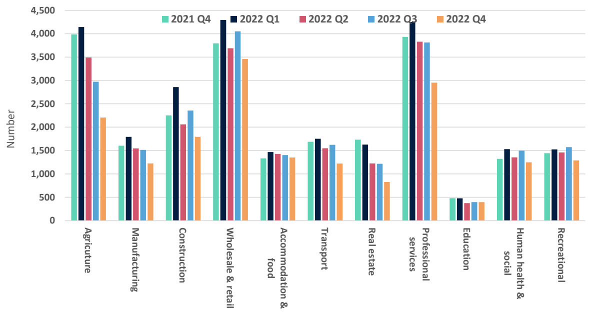
Chart 2: Gross lending by region



Source: UK Finance

Turning to the sector profile of borrowing applications and applications approved ***(Chart 3)***, this, unsurprisingly, followed a similar path to that seen in GB regions at the end of last year. Across the main sectors we report, applications and therefore the volume of applications approved was down on the previous quarter.

Chart 3: Number of approved loans and overdrafts by sector



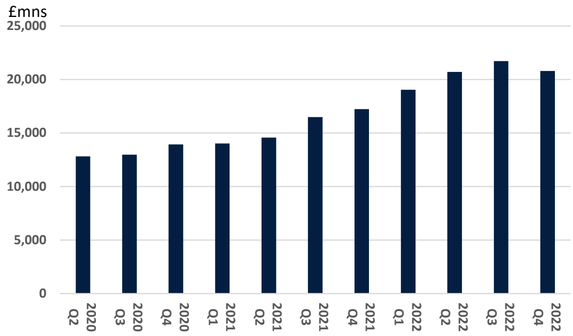
Source: UK Finance

The largest decline was recorded in the real estate sector, which saw a 30 per cent drop in loans and overdrafts approved. The most likely factor behind the fall in this sector is the mini-budget-related market turmoil which affected borrowing costs in October last year, this coincides with the sharp drop off in applications and approvals from SMEs in the real estate sector.

Our data shows a similar drop off in October across construction with lower levels of approvals seen in subsequent months compared with earlier in the year. While there was similar weakness in applications and approvals across the agriculture sector – this is consistent with the normal seasonal pattern of borrowing by this industry.

While there were some likely sector-specific drivers in play at the end of last year, these industries were not outliers, with declines in new lending approved widespread across the economy.

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

Consistent with the decline in other products, Q4 also marked the first quarter-on-quarter fall in invoice finance and asset-based (IF/ABL) lending advances since Q3 of 2021. The drop back in advances, by a relatively modest four per cent, follows a period of sustained post-Covid-19 recovery in the provision of finance through IF/ABL facilities.

Use of these products was particularly depressed through 2020 and early 2021 as firms substituted commercially provided working capital facilities for government-backed loans. However, as more normal trading conditions returned invoice finance and asset-based lending took off and advances surpassed pre-pandemic levels last quarter.

The dip in advances at the end of the year may reflect softer trading conditions and the general uncertainty weighing on firms' appetite for finance across the board. 2022 was nevertheless a strong year for the sector, with UK Finance's IF/ABL members supporting client businesses with a total turnover of over £300 billion for the first-time ever (£314 billion, up from £276 billion during 2021 and exceeding the previous record of £288 billion in 2018). While challenges are likely to persist in the short-term if, as expected, the UK economy tips into recession in the early part of this year, demand should recover with a broader return to growth later in the year.

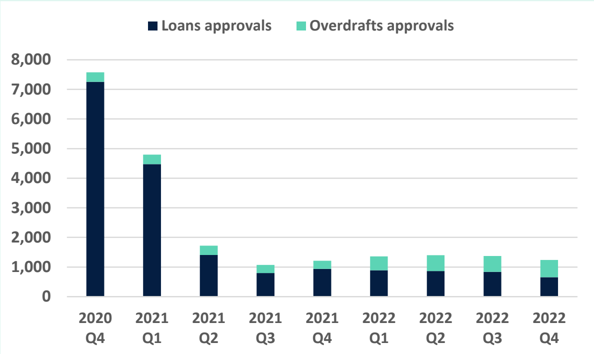
SPOTLIGHT ON: HOSPITALITY

As cost of living pressures continue to dominate the broader economic narrative, concern for the performance of consumer-facing sectors, such as accommodation and food services remains. Spending in the sector is discretionary and one area likely to be subject to cut backs as disposable incomes are squeezed. The industry had a rough ride through the Covid-19 and more recently has been hit with rising costs, pressure on pay and challenges with recruitment. Additionally, strikes on transport networks may have further weighed on activity at the end of 2022.

We looked at this sector in some detail in our 2021 Q2 Review, but here we provide an update on recent developments. Official data showed that output in the sector did fall back slightly in the second half of last year, but that followed a solid rebound at the start of 2022 and activity has recovered Covid-19 losses.

Across 2022 as a whole demand for new loan finance (***Chart 5***) from businesses within accommodation and food service activities tracked the broader national picture. There was a year-on-year decline of 57 per cent in the number of loans approved (compared with the 74 per cent in Great Britain as a whole).

Chart 5: Number of Loans and Overdraft approvals

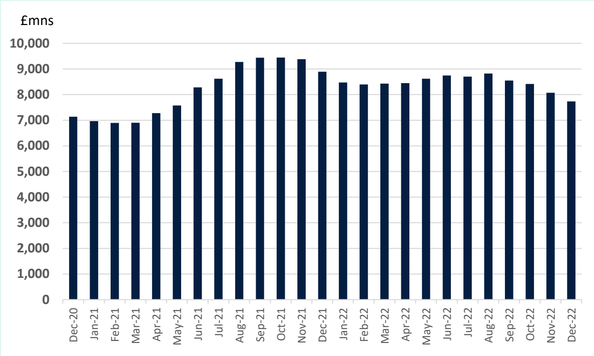


Source: UK Finance

However, there was a much stronger increase in overdraft approvals – an 80 per cent increase on 2021.

If the strong rebound in overdraft demand is a sign of the need for cashflow management solutions in the sector, the depletion of deposits in the industry is likely another. ***Chart 6*** shows the relatively faster draw down of cash deposits by SMEs in hospitality. In line with the aggregate picture, deposits started to decline in Q3, but this accelerated to a greater degree in the final months of 2022.

Chart 6: Deposit balances



Source: UK Finance

In December the level of accommodation and food services deposits were 13 per cent below the same period in the previous year – this compared with four per cent overall. The pressure on costs and potential challenge for the industry to pass these on to constrained households is likely to be factors explaining the developments in overdrafts and deposits in this sector.

There remains, however, a sizeable degree of headroom in available deposits compared with early 2020.While this will not be evenly distributed across businesses, it does provide some headroom to manage through what is predicted to be a challenging year as consumer spending is set to remain weak and inflationary pressures not expected to subside until later in the year.

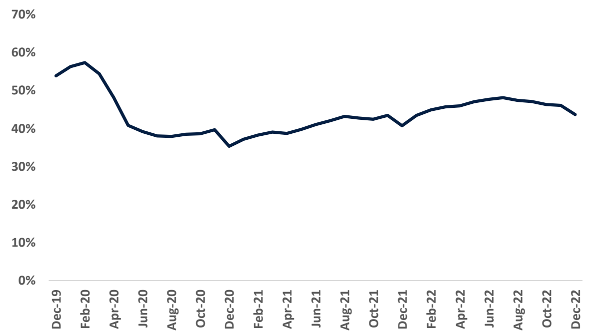
Financial headroom

While demand for new lending has stuttered, particularly loans and in the latter part of last year, a key theme from our Business Finance Reviews in recent years has been the availability of a good degree of headroom within existing facilities and cash deposits.

While Q4 does not mark a change in this overall picture for SMEs, there were some more signs that businesses were drawing on these a little more at the end of 2022.

We have already noted the increased demand for new overdraft facilities over the course of last year and ***Chart 7*** illustrates the trend in overdraft utilisation. Average utilisation has been running ahead of that seen in 2021, though the slight dip at the end of 2022 is in line with the usual seasonal trends. That said, the gradually upward drift in utilisation is still less than pre-pandemic norms, when utilisation rates ran closer to 60 per cent. This therefore, means that many SMEs will continue to have a reasonable buffer within existing overdraft facilities as firms continue to manage elevated costs and ongoing demand uncertainty.

Chart 7: Overdraft utilisation, percentage



Source: UK Finance

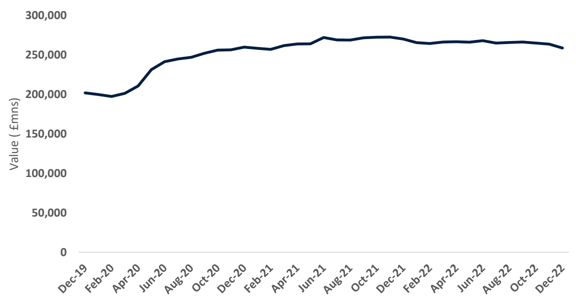
There has been slightly more movement in the level of cash deposits available to SMEs **(*Chart 8*)**. At the end of Q4 total deposits were three per cent lower compared with the end of Q3, marking the second consecutive quarter of decline. And in December the value of SME deposits was at its lowest level since February 2021.

This, however, represents only a relatively small decline compared with the growth in accumulated savings seen through 2020 and 2021. Deposits in December 2022 were still over 30 per cent high than before Covid-19 hit in February 2020.

Our data aligns with survey indicators, such as the SME Finance Monitor, which showed that in Q4, SME held the equivalent of 37 per cent of turnover in credit balances, down from the 2022 Q1 peak, but well ahead of the 24 per cent of turnover reported in 2019.

The sector profile of deposits shows a modest degree of variation – the general picture is one of stability, with a gradual reduction in the second half of last year. The exception being agriculture and construction, with posted further growth in cash deposits in the latter months of last year.

Chart 8: SME Deposits



Source: UK Finance

SPOTLIGHT: LENDING IN THE REGIONS

As part of this Review's 2022 round up, this quarter's spotlight takes a look at trends in the regions of Great Britain.

Data from the EY Item Club show that all GB regions expanded in 2022, with the strongest growth in gross value added (GVA) in London, with growth in Scotland and the East of England also outpacing the UK average. Lower down the growth league table is the South East and West Midlands, with the East Midlands recording the slowest pace of expansion last year.

In recent years there has been an unusual degree of uniformity of lending patterns across regions – largely as a consequence of the widespread impact of Covid-19 and the various lockdowns and other social distancing restrictions and the universal availability of government-backed loans. Did this consistency hold in 2022?

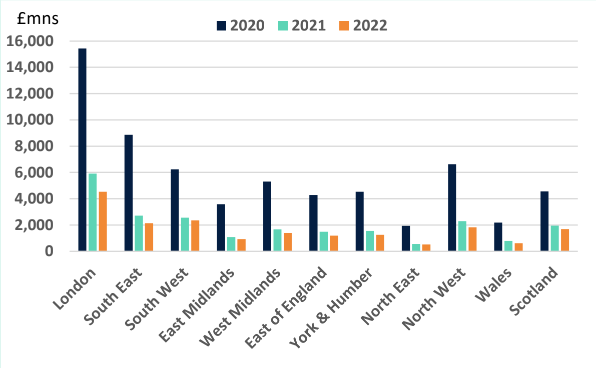
In short the answer is mostly *yes.*

Gross lending, discussed earlier, has followed a largely consistent path across the regions over the past three years, with all England regions, Scotland and Wales seeing a notable drop off in 2021 and a further drift down through 2022 ***(Chart 9)****.*

Most regions saw the rate of gross lending decline clustered around the GB average, with nine of the 11 regions covered by our data seeing a fall of between 15% and 23%, compared with the nation decrease of 18%. Smaller falls, of eight per cent, were reported in the North East and South West.

Overall, the share of gross lending last year continues to track the share of businesses in each region.

Chart 9: Gross lending, £bn

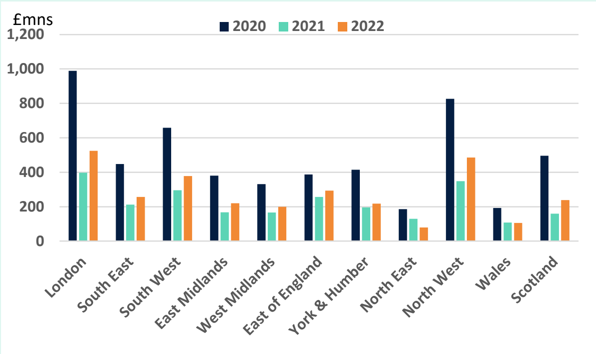


Source: UK Finance

However, as ***Chart 10*** *shows there is a little more variation in the uptake of new overdraft facilities by region. Across Great Britain as a whole the value of overdrafts approved in 2022 was nearly a quarter higher (23 per cent) than 2021. Throughout 2022 we have attributed the recovery in overdraft demand to businesses' cashflow management needs in the face of higher costs and broader trading conditions normalising post-Covid-19.*

There was, however, a much larger percentage increase in the value of overdrafts approved in Scotland (49 per cent), the North East (40 per cent) and East Midlands (32 per cent). In contrast, new overdraft approvals showed a marked 39 per cent year-on-year fall in the North East and a more modest two per cent decrease in Wales. Growth was also more muted in Yorkshire and Humberside.

Chart 10: Overdraft approvals, £ millions



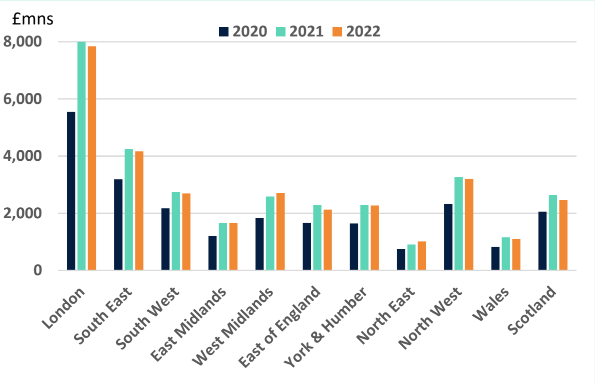
Source: UK Finance

Regional lending will be a function of the sector mix and demographics of the business population. With respect to sector make up, the profile of industry sectors in the North East *and Wales is not sufficiently different to GB to explain the variation. In the North East, the relatively stronger lending through loans compared with other regions may be balancing out the lower overdraft demand.*

Thirdly, ***Chart 11*** *looks considers the profile of repayments by region. Across Great Britain, total repayments amounted to over £31 billion last year, a decline of two per cent on the previous year. More than half of regions followed this national trend last year.*

Of the outliers, Scotland, Wales and the East of England saw a slightly larger percentage decline in total repayments. The North East and West Midlands bucked the GB-wide trend with a year-on-year increase in repayments, by four per cent and 12 per cent, respectively. In the North East, this growth came on the back of a smaller than average rise in 2021.

Chart 10: Repayments, £ millions



Source: UK Finance

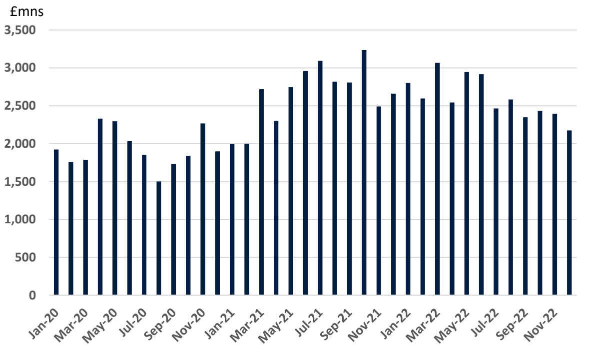
Repayments

A finally, turning to repayments (***chart 12***). Last quarter we noted that the value of repayments had edged down from the elevated levels seen since government-backed loan repayments began to fall due in mid-2021. This moderation continued, but at a reduced pace in the final months of last year.

Total SME repayments edged down by just over five per cent in Q4 compared with Q3, coming on the back of a 12 per cent quarter-on-quarter fall in the three months to September. As noted in the 2022 summary previously, this still represents higher, on average, repayment values than prior to the pandemic.

This slight easing is reflective of the slow down in SME fully repaying government-backed loans and is consistent with government figures, which showed that in September 2022 a total of seven per cent of BBLS has been fully repaid, rising to 11 per cent in the most recent data release in February. However, official data also show that the vast majority – over three-quarters of the remainder – remain up to date as firms continue to make repayments. To that end, we should continue to see repayments running at a similar level in the coming year.

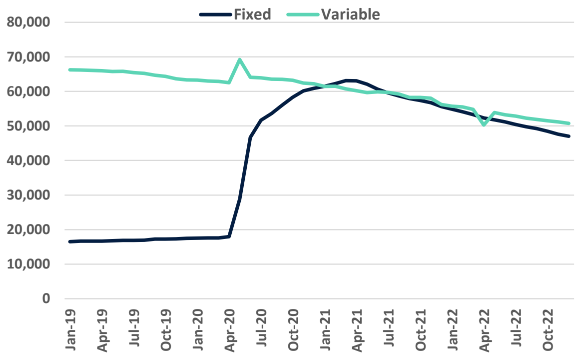
Chart 12: Value of repayments



Source: UK Finance

Chart 13 shows that SMEs are repaying both government-backed loans secured during the pandemic and other outstanding obligations, with the stock of loans on both fixed and variable rates declining through 2022. The stock of outstanding loans on fixed interest rates, and therefore unaffected by recent and future rate rises, accounts for just under half of the total stock.

Chart 12: Stock of outstanding loans on fixed and variable rates, £ million



Source: UK Finance

Outlook for SME finance

2022 was another year of uncertainty for SMEs. Businesses were challenged with forecasts of recession, inflationary pressures not seen for four decades and a faster pace of interest rate rises than expected at the start of the year.

The consequences of financing were a softer demand for new loans but a modest recovery in products to support cashflow management. The turmoil in financial markets at the end of last year appears to have delivered a further hurdle to firms' plans to borrow and invest.

Markets have stabilised following the reversal of many of the Truss government's tax cuts, which may prompt something of a rebound in lending. In addition, the Bank of England looks likely to be near the end of its monetary tightening cycle. This should provide a more stable backdrop helping SMEs to plan for the future. But they will, to a large extent also be navigating many similar challenges – a higher cost base and weak demand – at least in the first half of 2023.