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 2023.

David Raw, Managing Director of Commercial Finance, comments:

"The economy and SMEs have demonstrated resilience in the face of more challenging trading conditions and significant cost pressures, obstacles that we expect to ease gradually over the course of this year.

"Against this challenging backdrop, demand for finance has showed some early signs of recovery, although this has not yet fed through into the gross lending figures which showed another decline in the first quarter, and muted investment intentions and recent rises in interest rates will continue to act as a drag on demand for finance. SMEs do continue to have some flexibility within existing facilities and deposits, which will support many through another bumpy year."

2023 Q1 HIGHLIGHTS

- **Gross lending by the main high street banks fell to a post-pandemic low of £3.7bn in 2023 Q1.**
- **Loan and overdraft applications rebound in Q1**
- **And approvals pick up across all sectors.**
- **IF/ABL advances edge down following a strong 2022.**
- **Decumulation of deposits picks up pace, but with some notable sectoral differences.**
- **In aggregate, SMEs retain a good degree of headroom across deposits and existing facilities.**
- **Repayments drop back again, but stock of fixed-rate borrowing continues to fall.**

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Economic outlook

The backdrop to this quarter's Business Finance Review remains one of anaemic global and UK economic growth. GDP in the UK grew by 0.1 per cent compared with the previous quarter – sluggish, but better than had been expected. The economy has essentially flatlined for the past 12 months but escaped dipping into recession, a trend also evident across most G7 comparators.

Looking at the composition of growth at the start of 2023 there are few signs of momentum across many sectors. Services expanded by 0.1 per cent, however consumer facing activities continued to struggle as household budgets continued to feel the strain from rising inflation.

A more significant downward contribution to the service sector, however, came from the ongoing effects of strike action, which affected transport, health, and education activity in the first quarter. In addition, activity in the retail sector was held back by a rainy March.

Manufacturing fared slightly better at the start of the year, posting another 0.5 per cent expansion on the quarter, with growth in food production and foundation sectors such as metals and chemicals. Though this is coming on the back of a very weak 2022 and current activity indicators, such as the Manufacturing Purchasing Managers' Index (PMI), point to continuing challenges for manufacturers from subdued global demand and intensifying competition in overseas markets.

Construction was the strongest performer on the quarter – with output increasing by 0.7 per cent. Activity was buoyed by a rise in housing-related repair and maintenance work. We will look at trends in the sector in more detail in our spotlight.

Given the stuttering performance of a number of sectors, it is unsurprising that business investment has also remained relatively flat in recent quarters. In the first three months of 2023 investment rose by 0.7 per cent, which continued to leave it below pre-pandemic levels. The ONS noted that some businesses reported that the super-deduction had encouraged them to bring forward or embark on additional investment before the incentive ended at the end of March. The higher interest rate environment may also be contributing to some projects failing to get a green light.

Looking ahead, the ONS Business Insights and Conditions Survey (BICS) points to a very gradual improvement in business confidence about future trading conditions. That said, those expecting to see things improve in the next 12 months still remain a minority. The key challenges of 2022 remain in play – concerns about cost pressures and the strength of demand, given the ongoing cost of living squeeze on consumers, and a still-fragile outlook for global demand.

Consumer-facing sectors continue to see sentiment across households in the doldrums. There is light at the end of the tunnel for energy prices, with government extending the energy price guarantee at the spring budget, and more recently, the new price cap which takes around £400 off the average annual household bill from July.

Nevertheless, elevated rates of inflation across other items, notably food, clothing and services persists. April's CPI print, at 8.7 per cent, while the first single digit reading since last August, was higher than forecasters and the Bank of England were hoping. Moreover, high rates of inflation on these items weigh more heavily on lower income households.

The Bank's Monetary Policy Report highlighted that the risks to the inflation outlook were skewed to the upside, and it may prove more persistent than the central forecast. It is unclear, therefore, whether the end of the Bank's monetary tightening cycle is near, and markets expect another interest rate rise when the MPC meets in June, and potentially more in the second half of the year.

Indeed, after the last inflation data release market expectations for interest rates hit nearly 5.5 per cent by the end of the year. This has led to some recent volatility in mortgage rates and will also feed through into borrowing costs for SMEs.

Similar pressures are providing challenges to demand in key overseas markets – inflation, driven in part by the continuing conflict in Ukraine, central banks tightening monetary policy and in the US concerns about financial stability. While for most economists, the central forecast is for a moderate pace of global expansion in the coming years, this assumes no further risks materialise and that growth will be more subdued than before the pandemic.

There is also now a general consensus that the outlook for the UK is one of moderate growth this year and next. With the prospect of recession much diminished, the Bank of England, International Monetary Fund and OECD, for example, have revised up their GDP projections for the year to a shade under half a percent.

Unemployment is expected to remain low, which should also help to shore up consumer sentiment. Though tightness in the labour market is double-edged sword for businesses, as upward pressure on wages continued at the start of the year and some sectors are struggling to fill vacancies, impacting on their ability to meet demand.

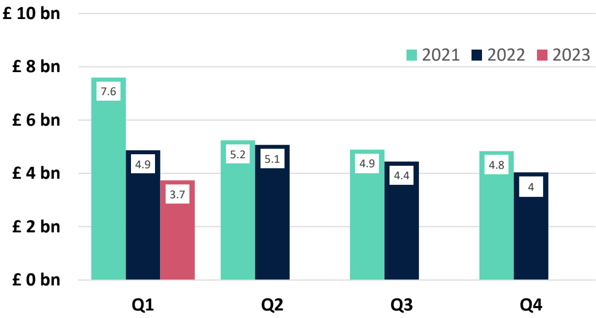
SME finance

Last quarter we noted a weak end to 2022 in terms of demand for finance amongst SMEs. Applications for new loans in 2022 Q4 were sharply down on the same period a year ago, and growth in overdraft applications, which had shown signs of recovery in the first half of 2022, came to a halt.

The financial market consequences of the mini budget continued to cast a shadow across the economy, and the growth outlook for the UK and global economy was fragile going into 2023. Moreover, the increase in borrowing costs, discussed in the previous section, are likely to have applied an additional break on SMEs' appetite for new finance.

The outcome, in terms of flows of new lending to businesses from the main high streets banks, was, therefore, similarly weak in the first quarter of 2023. Total new lending across the seven lenders in our sample was £3.7 billion (**chart 1**), marking a low point in the post-pandemic period.

Chart 1: Gross lending to SMEs



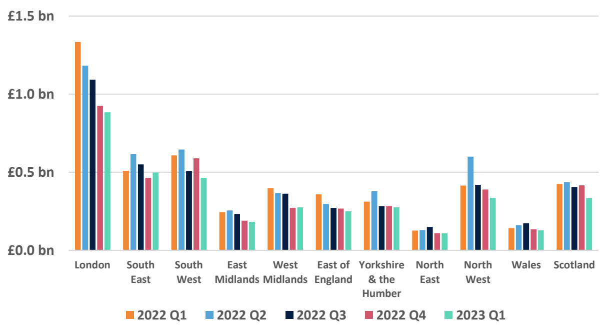
Source: UK Finance

While it should be noted that increased competition in the SME lending market means finance providers other than the main retail banks are becoming increasingly important in meeting the finance requirements of SMEs, our data nevertheless signal some headwinds for SMEs in recent quarters. The weakness in our data at the end of last year and the start of this one is broadly consistent with that reported by SMEs in the BVA/BDRC SME Finance Monitor, which pointed to fewer than five per cent of SMEs having a need for external funding, continuing the downward drift in demand for finance seen since the end of the Covid-related loans schemes.

Quarter-on-quarter declines in new lending were evident across almost all GB regions again in Q1 (**chart 2**). The largest falls were seen in the south west and Scotland, though these regions had bucked the previous quarter's declining trend by recording an increase in new lending in Q4. The fall in new lending at the start of the year, therefore, puts these regions on a similar trajectory to that seen in other parts of Great Britain. In contrast, after falling sharply in the final three months of 2022, lending in the south east saw the largest increase at the start of 2023 – rising more than seven per cent compared with Q4, taking gross lending to a similar level to that seen in the same quarter a year ago.

After a period of stability in the first three quarters of 2022, the weakness in lending to west midlands SMEs in Q4 persisted at the start of 2023. In the past six months, lending in this region has seen one of the largest falls compared with the preceding six months, only exceeded by the decline in lending in the north west. The trends in these regions may be a consequence of subdued loan applications and approvals across the dominant manufacturing sectors in the latter part of last year. It is London, however, that has seen the most persistent weakness in new lending, with 2023 Q1 marking the fifth consecutive quarter of decline – the only region to see continuous falls over this period.

Chart 2: Gross lending by region

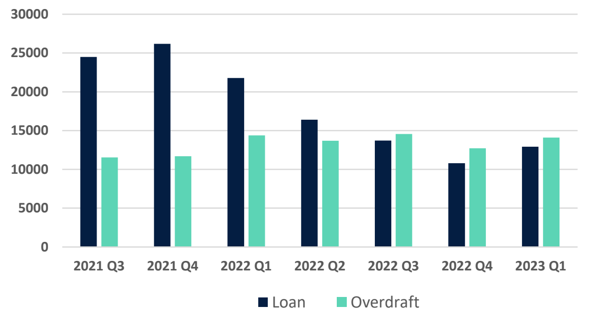


Source: UK Finance

As previously noted, applications for finance fluctuated at the end of last year as SMEs processed the implications of last autumn's market turmoil and the increases in Bank Rate.

There has been a rebound in applications for both loans and overdrafts in the most recent quarter, with banks reporting quarter-on-quarter growth of 20 per cent and 11 per cent respectively (**chart 3**). Overdraft application volumes broadly returned to where they were before the mini budget, however loan applications are still a long way off pre-pandemic trends. Across both loan and overdraft applications there appears to have been some strengthening in demand towards the end of the quarter, an indication that demand may be turning a corner.

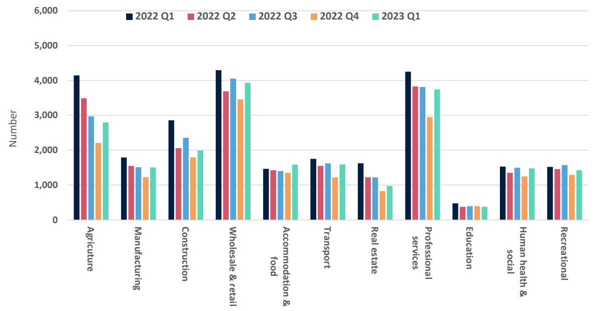
Chart 3: Number of loan and overdraft applications



Source: UK Finance

Chart 4 illustrates how recent applications have translated into approvals across industry sectors. Following last quarter's weakness, when almost all sectors reported a notable drop in the volume of loan and overdraft approvals, this quarter marks an across-the-board increase in approvals.

Chart 4: Number of approved loans and overdrafts by sector



Source: UK Finance

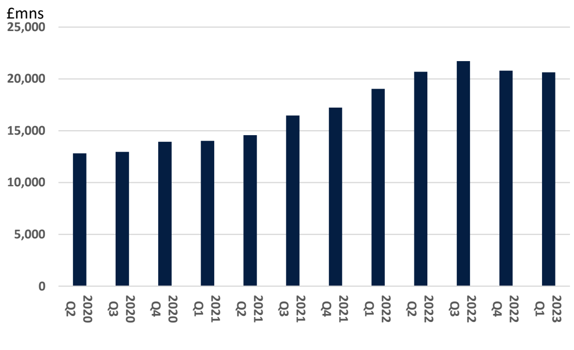
While **chart 4** shows a broad based increase in approvals across all sectors at the start of this year, the recovery in approvals to accommodation and food service SMEs and those in health and social care was particularly notable. For these sectors approvals in Q1 were higher than the average seen in the first half of 2022.

Invoice finance and asset-based lending (IF/ABL) advances have shown a much stronger growth trajectory compared with other forms of finance since the end of the government-backed loan schemes in 2021. In 2022 as a whole, funds provided to clients bounced back strongly with the mean end of quarter advances figure for 2022 reaching almost £21 billion. This was up 32 per cent on the 2021 figure of just under £16 billion.

The 2021 figures reflected the impacts of both the suppression of economic activity, as well as the displacement of commercially provided facilities that occurred as a consequence of various government interventions. Whilst client sales and advances returned in 2022, overall client numbers were slower to recover. There was a fractional recovery to 34,900 clients of all sizes, but still well down on the 40,000 and above seen in the years preceding the pandemic.

2023 started in a similar vein to that seen at the end of 2022. Advances were broadly stable (**chart 5**) at a shade under £21 billion at the close of the first quarter. Whilst this represents growth of eight per cent compared with the same period a year ago, it is actually the slowest since the IF/ABL rebound got underway in mid-2021.

Chart 5: Value of invoice finance and asset-based lending advances



Source: UK Finance

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

Taken together with the recovery in demand for overdrafts, the continued robustness in supply of IF/ABL products continues to point to the important role that specialist working capital finance is playing in supporting SMEs and the ability of the sector to support clients across the economic cycle, including in the recent period of elevated uncertainty.

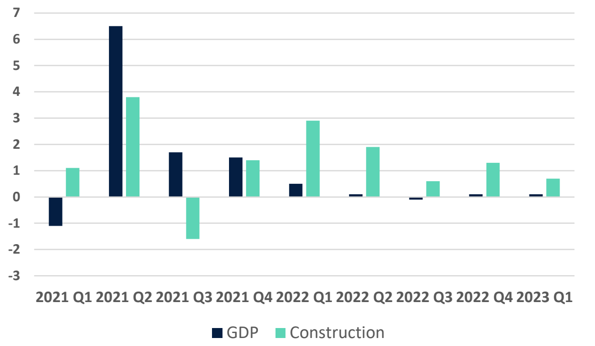
SPOTLIGHT: CONSTRUCTION

We last looked at trends in lending to the construction sector in 2021 Q3. Back then we noted the relative resilience of the sector through and emerging from the pandemic, but the challenges facing construction firms from supply chain disruptions and skills shortages.

The latest data from ONS (**chart 6**) shows that growth has continued largely uninterrupted in the intervening period with six consecutive quarters of growth. Between our last construction spotlight in 2021 Q3 and 2023 Q1, construction output has expanded by over nine per cent, compared with GDP growth of two per cent over the same period. Construction output now stands nearly seven per cent above per-pandemic levels.

All components of construction activity expanded over this period, with the exception of new infrastructure work, but there was particularly strength in areas including housing repair and maintenance and new industrial work.

Chart 6: Quarter-on-quarter growth in output, percentage



Source: ONS

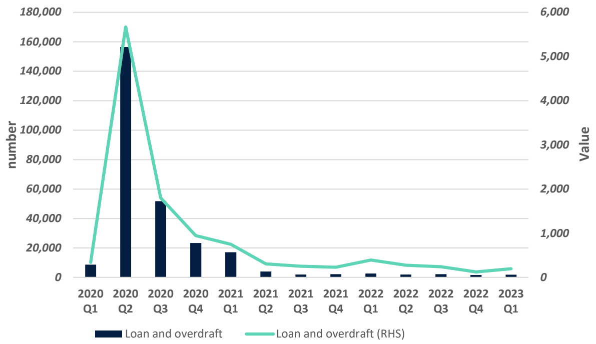
Some of the headwinds discussed at the end of 2021 have eased. Notably, recent survey data such as the ONS Business Insight Survey and the construction Purchasing Managers' Index (PMI) point to improved supply conditions and moderating cost inflation.

Pay growth has also normalised following very rapid wage inflation in the early part of 2022. While hard-to-fill vacancies remain, recruitment difficulties in the sector have eased somewhat.

Looking to the future, the construction PMI notes relatively solid confidence levels due to resilient demand conditions, but there are concerns about subdued housing market activity and rising interest rates.

Turning now to finance developments in the construction sector, businesses' appetite for finance dropped back sharply last year, in line with that seen in other sectors at the end of last year. As **chart 7** illustrates, there has been a solid rebound in the value and volume of loans and overdrafts approved to the sector at the start of 2023. And similar to the wider SME picture, and approvals rose towards the end of the quarter.

Chart 7: Number and Value of loan and overdraft approvals



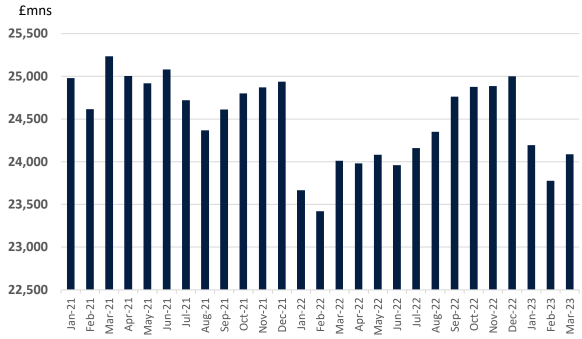
Source: UK Finance

In addition, mirroring the broader upturn in demand for invoice finance and asset-based lending generally, our data shows consistent year-on-year growth in numbers of construction clients supported by these products over the past two years, with numbers in the most recent quarter the highest since the series began in 2015. This points to the breadth of financing options available to support cashflow requirements in this sector.

In contrast to the decumulation of deposits seen in aggregate in our data through 2022 (see next section), deposits held by SMEs in the construction sector ended the year broadly unchanged from the end of 2021. At the start of 2023, there has been a more apparent decline in construction cash deposits – a near four per cent drop. However, this appears to follow a seasonal pattern, with similar declines seen in the same period in previous years.

It is not clear, therefore, whether cash deposits in construction will follow the same trend as that seen in the wider SME population and continue a downward trajectory this year. With cost pressures easing, it may be these continue to hold up.

Chart 8: Deposits, £m



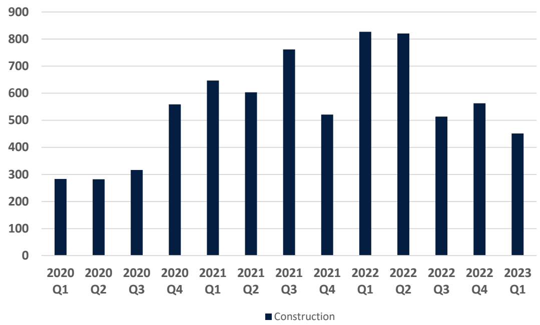
Source: UK Finance

Finally, turning to repayments. Construction SMEs accessed government-backed loans during the pandemic in line with their share of the business population. Over the last 18 months, SMEs in this sector have, therefore, been subject to the same repayment obligations as the wider SME community.

The quarterly profile of repayments (**chart 9** shows that repayments peaked in mid-2022 – in line with repayments of BBLS and CBLS lending falling due. The profile has fallen away thereafter, and somewhat faster than the aggregate repayment trend. This could indicate that construction SMEs were somewhat faster out of the starting blocks in meeting CBILS and BBLS repayments.

Despite the drop off in repayments in recent quarters, these continue to run ahead of pre-pandemic trends. The ONS BICS survey continues to point to solid confidence levels about continuing to meet those obligations.

Chart 9: Repayments, £m



Source: UK Finance

Looking ahead continued growth in the sector will continue to depend on the larger infrastructure activity in the pipeline being mobilised. This will offset risks from a softer housing outlook, given the higher interest rate environment. And over the longer term, the UK's net zero ambition will provide both opportunities and challenges for the construction sector. The continued requirements for skills and labour will need further attention from industry, government and training providers to ensure recruitment difficulties are contained.

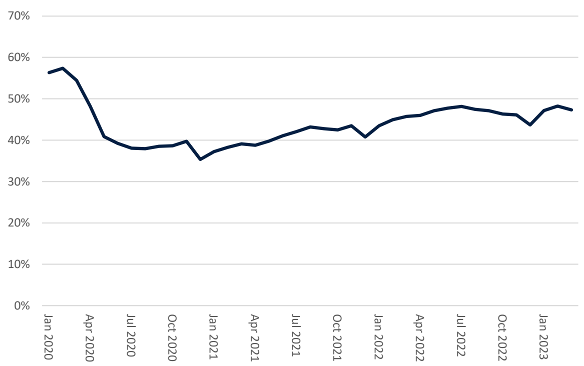
As we can see from our data, the industry has a large degree of available headroom as well as making use of the breadth of financing options available to support investment and working capital needs.

Financial headroom

For the past two years the headroom that SMEs, in aggregate, have within their existing cash deposits and lending facilities has been a dominant theme of our reviews. For many small and medium-sized businesses this headroom will have been an important cushion in dealing with the various economic challenges they have faced into, even after emerging from the pandemic.

Weak growth, rising input costs and energy price spikes have all borne down on businesses over the past year. Nevertheless, we have seen minimal depletion of available resources over this period. The latest data on overdraft utilisation and available deposits reveal are largely unchanged trend at the start of 2023.

Chart 10: Overdraft utilisation, percentage



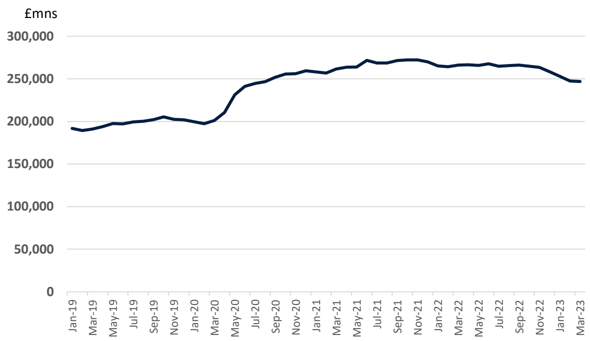
Source: UK Finance

Starting with overdraft utilisation (**chart 10**), this remained broadly stable in the first three months of the year, averaging 48 per cent. This utilisation rate is fractionally higher than the average seen across 2022 as a whole (46 per cent).

There is, however, some sector variation. Notably the accommodation and food service sector (which we looked at in more detail in the 2022 Q4 Review), which has seen stronger growth in overdraft demand than the SME average and more recently a significant uptick in utilisation relative to other industries. Average utilisation amongst accommodation and food SMEs was just under a third last year, but this jumped to 44 per cent in the most recent quarter – potentially reflecting the ongoing cost pressures facing this sector.

Larger than average increases in overdraft utilisation can also be seen in wholesale and retail, and recreation and personal services. There may be additional seasonal factors in play in these sectors.

Chart 11: SME Deposits



Source: UK Finance

SME deposits have been gradually drifting lower over the past year and at the start of 2023 took a slightly larger step down. At the end of the quarter total deposits were nearly five per lower when compared with the end of the previous quarter. This marks the largest quarterly decline since the pandemic and puts the level of deposits at the lowest level since August 2020.

Declining deposits were seen across all the main sectors within our sample, with the largest falls seen in accommodation and food, and agriculture.

While the current level of deposits continued to provide a solid cushion for SMEs, it should also be noted that that based on analysis of the SME Finance Monitor data almost 312,000 SMEs hold more than £85,000 in credit balances, over the FSCS protection limit.

Repayments

Finally, repayments are shown in **chart 12**. Repayments were gradually declining quarter-on-quarter through 2022 to hit a post-pandemic low in the final three months of the year. We have interpreted this trend as a slowing in the volume of SMEs fully repaying government backed facilities as well as the relatively lower levels of new lending that we have seen in our data since the closure of the Covid-19 loans schemes.

On a quarterly basis, the decline in repayments continued in the first three months of 2023, with a seven per cent fall on 2022 Q4. However, January marked a low point for repayments and they accelerated in the remainder of the quarter, with March repayment values in line with that seen in the second half of last year. Overall, the stock of fixed-rate loans has seen the largest decline over the past 12 months, pointing to SMEs continuing to pay down Covid-related funding.

Chart 12: Value of repayments

Source: UK Finance

Outlook for SME finance

2023 is starting on a slightly stronger note as the UK economy has avoided tipping into recession and the growth outlook, both here and in overseas markets, has gradually improved, even with the conflict in Ukraine persisting.

Many SMEs will, however, not feel that they are out of the woods yet. High inflation is proving more persistent, which will be a worry for sectors dependent on improving consumer incomes and sentiment.

And while the domestic and international backdrop has certainly stabilised, it feels like business sentiment has not improved to the extent that we might see a material uplift in plans to invest in new capacity for the future.

In terms of what that means for the outlook for SME finance, there are tentative signs in our data that we may just have passed the low point in demand. Signs of a return of demand for new working capital facilities is promising. If the outlook does indicate that the economy may be gaining a little more momentum, we might hope to see plans for investment and expansion return in the coming quarters.