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 in the first half of 2023.

David Raw, Managing Director of Commercial Finance, comments:

"The UK economy has proved a little more resilient than some expected in the first half of 2023, with the three broad economic sectors of services, production and construction posting modest growth over the past six months. Against this stable but subdued backdrop, SMEs' finances have remained largely unchanged.

"Gross lending in the most recent quarter was flat and demand for new finance continues to trend below pre-pandemic levels. In this context, it should be noted that SMEs still have a good degree of headroom in terms of cash deposits and flexibility within existing overdraft and invoice finance facilities.

"With higher interest rates than SMEs have experienced for more than a decade, and ongoing uncertainty about the demand outlook, we expect demand for finance from SMEs to remain muted in the near term overall."

2023 Q2 HIGHLIGHTS

- **Gross lending by the main high street banks remained subdued in Q2.**
- **Regional variation in new lending re-emerges after broad based falls in Q1.**
- **Similarly mixed picture across sectors for new finance approvals.**
- **Little movement in working capital finance in the quarter, but overdraft utilisation continues to drift up.**
- **SME deposits rise after falling in the previous two quarters.**
- **Repayments stable and the reduction in loan stocks on fixed rates continues its more rapid decline.**

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Economic outlook

The UK economic news in Q2 was a little better than expected. GDP expanded by 0.2 per cent, up on the previous quarter's 0.1 per cent growth. This confirms most forecasters' expectations that the UK will likely avoid recession this year.

Q2 saw rises in output across all three main sectors of the economy; services output increased by 0.1 per cent, production and construction fared a bit better with output growing by 0.7 per cent and 0.3 per cent respectively.

Within services, the sub-sector performance was typically more variable. Good weather and an extra bank holiday in the quarter boosted growth in accommodation and food services. This was the first quarter of growth for this sector in a year, during which cost of living pressures have been weighing on households. A sunny June also helped the high street, with a pickup in retail sales.

Elsewhere in services, the numbers continued to be impacted by industrial action. Activity in health, for example, showed quite a bit of monthly volatility in the quarter as a result of strikes by junior doctors.

Construction saw its seventh consecutive quarter of growth, though the pace of quarterly expansion has slowed in the first half of 2023 compared with that seen through 2022. Decent weather was again a positive for the industry over the quarter, but the Office for National Statistics (ONS) notes that cost of living pressures and the weaker outlook for the economy are depressing new orders together with a slowdown in government spending on larger infrastructure projects.

Turning finally to production, manufacturing had a very strong quarter, growing by 1.6 per cent and marking the third straight quarter of expansion. The ONS data is somewhat at odds with the more downbeat survey evidence from the S&P Global purchasing mangers' index, however. The majority of manufacturing sub-sectors grew in Q2, aided by a notable easing in input cost pressures and there was particular strength in transport equipment, which includes vehicle manufacture.

There was also some positive news on business investment, which again contributed positively to GDP growth in Q2, however delving into the details, ONS notes that this was primarily investment in aircraft, with investment spending on ICT, and machinery and equipment, dropping off, as expected, with the end of the super-deduction incentive.

While there were a few positive growth headlines in Q2, the biggest picture remains a relatively weak one, and a spell of good weather is not going to lift the UK economy onto a higher growth path. The current average forecast for GDP growth this year remains at 0.3 per cent, with only a modest improvement (0.7 per cent growth) in prospect for 2024.

Indeed, there are few obvious drivers of stronger growth in the near term. While inflation has fallen back from the double-digit highs from earlier this year and will drop further with cuts to the energy price cap, household budgets continue to remain under pressure. That will limit the contribution that household spending will make to growth at least for the remainder of this year.

And for internationally exposed businesses, there is a similarly subdued global outlook and world trade indicators have been running below trend since the end of last year, according to the World Trade Organisation (WTO). Demand is notably weak in the European Union and China as a result of high inflation and tighter monetary policy. Indeed, in the eurozone GDP was flat in Q2 and Germany and the Netherlands have tipped into recession, according to provisional Eurostat data.

There is little to suggest that a turnaround in the international outlook is in prospect. Global

PMIs have been weakening and start the third quarter in, or close to, contractionary territory, and consumer confidence readings are also fragile.

For UK SMEs falling energy prices are contributing to a moderation in the squeeze on margins and these cost pressures are being cited less frequently as a source of business concern (and in July were overtaken by concerns about falling demand). In addition, some loosening in the labour market has led to fewer businesses reporting difficulties recruiting staff – though challenges remain in sectors such as hospitality, and transport and storage.

However, as some problems dissipate others emerge. More businesses are noting the challenge of higher interest rates according to the ONS business conditions survey. The Bank of England has now raised interest rates on 14 occasions and Bank Rate now stands at 5.25 per cent. The persistence of inflation and Monetary Policy Committee (MPC) concerns that elevated core inflation and strong wage growth might make the job of bringing CPI back to target more difficult have been key factors behind recent decisions.

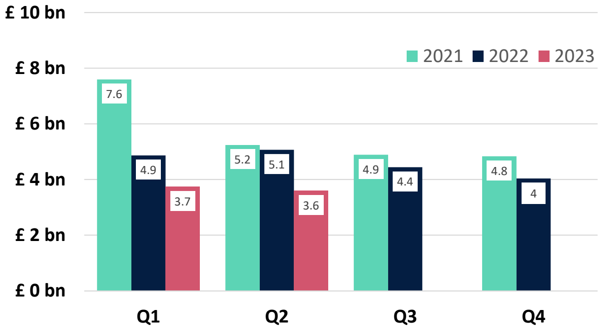
Most forecasters now expect Bank Rate to be at or close to the peak. But not that interest rates will head much lower over the course of the next year. As we will note in the next sections, higher interest rates are already limiting businesses' appetite to borrow, and that brake is likely to be in place in the near term.

SME finance

In 2023 Q1 UK Finance data for gross lending to SMEs by the main high street banks hit a post-pandemic low of £3.7 billion. Applications for new finance had been subdued since the autumn in the face of rising interest rates and an uncertain demand outlook. While there were some tentative signs that demand might be turning a corner towards the end of Q1, overall applications in the first quarter of the year were nevertheless down on that seen in the first half of 2022.

The consequence of this was another fairly weak quarter for gross lending in the three months to June. The value of new lending (***chart 1***) was broadly unchanged at £3.6 billion.

Chart 1: Gross lending to SMEs

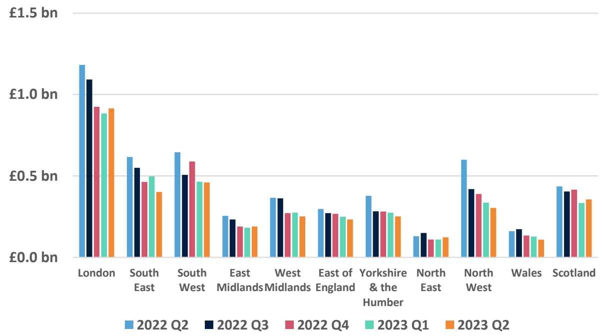


Source: UK Finance

As we highlight in our reviews, the data we report covers a subset of the SME lending market, with the increase in competition in previous years seeing a range of entrants into the market to support SMEs. However, looking at data from the Bank of England (which covers a greater share of the market), we see a similar downward trend in gross lending over the past two quarters.

The Bank of England estimates indicate that whole market gross lending in the first half of 2023 was 12 per cent lower than the previous six-month period. The corresponding decline in gross lending across our sample for the same period was similar at 14 per cent.

Chart 2: Gross lending by region



Source: UK Finance

Last quarter we noted flat or falling gross lending across almost all regions, with notable declines in Scotland and the south-west of England. Amidst the largely flat picture overall on new lending in the most recent quarter, there is, however, a greater degree of regional variability (***chart 2***).

There were quarter-on-quarter increases in gross lending to SMEs in four regions in Q2 – London, the east midlands, Scotland, and the largest at 12 per cent, the north-east. With the exception of Scotland, the rise over the quarter takes the level of gross lending more or less back to levels seen at the end of 2022.

Elsewhere in Great Britain, gross lending dropped back. The fall was particularly marked in the south-east, but this followed expansion in the previous quarter. There was also a near ten per cent decline in gross lending to north-west SMEs. This region stands out somewhat, as it has now recorded four consecutive declines in gross lending.

The dominance of manufacturing in the region may offer some explanation for the trend. Gross lending to manufacturing SMEs had dropped back steadily over the past year. However, there are likely other factors at play.

Looking through the variation in regional lending flows from quarter to quarter, there are more modest differences in lending patterns looking at the first half of the year compared with the preceding six months. In almost every part of GB we note lending declines in H1 similar to that seen across GB as a whole (around 14 per cent). The exception is the north-west and Wales where gross lending is over a fifth down over the same period.

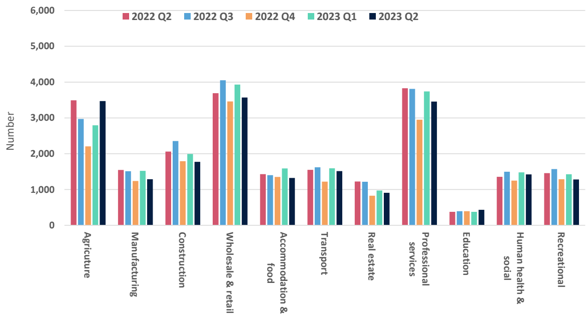
Turning to finance approvals, which is a potential indication of future lending flows, the total number of loans and overdrafts approved to SMEs in the quarter edged down slightly, suggesting that approvals have more or less returned to where they were prior to last autumn's market turmoil rather than continuing the recovery seen in Q1 (***chart 3***). On this basis, we are likely to see overall gross lending remain pretty flat in the near term.

Total approvals are higher than the 2022 Q4 lows, but the trend towards higher volumes of overdraft approvals compared with loans persisted for the fourth quarter running. While overall volumes of overdraft approvals were down on the previous quarter, there was a material increase (24 per cent) in values approved.

Similar to the regional variation noted across new lending over the past quarter, we see a mixed picture across sectors in our approvals data (***chart 3***). Over the past nine months we can see three broad categories of sector – those that saw a sharp fall in approvals last autumn and a fairly sustained increase in the past six months; those sectors which saw a temporary rebound after the market turmoil lows in 2022 Q3; and those seeing a fairly flat trend over the period.

Those sectors seeing a rebound in approvals in the past six months are in the minority, including agriculture and transport, storage and communication. We will look at the former of these in more detail in this quarter's sector spotlight.

Chart 3: Number of approved loans and overdrafts by sector



Source: UK Finance

Most of the remaining sectors saw a short-lived bounceback in approvals in Q1, but this recovery largely went into reverse in the three months to June. This includes sectors such as manufacturing, wholesale and retail, construction, and to a lesser extent accommodation and food services.

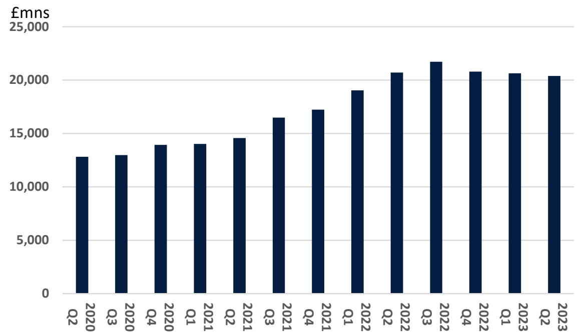
Over the past six months there has been a shift in the interest rates outlook, which may have led to some businesses putting new borrowing plans on hold. Earlier in the year many forecasters were expecting Bank Rate to peak at a little over four per cent. But persistent inflation, as noted in the introduction, led to some re-evaluation of the path of Bank Rate, with the prospect of rates at or over six per cent seemingly back on the table in early summer. This may have weighed to a greater extent on more consumer facing sectors.

Finally, the more stable sectors include real estate, which has been approved to drop back and stay these over the past three quarters, and more public-sector related sectors, such as education and health.

Like most of the other indicators discussed in this review, recent trends in invoice finance and asset-based lending IF/ABL have also been relatively stable in the past two quarters.

2022 Q3 was the post-Covid-19 high point in terms of IF/ABL advances and client numbers. Subsequently, there has been a gradual moderation in the past three quarters, but both client numbers and advances were only fractionally down (0.1 per cent and 1.5 per cent respectively) compared with the same period a year ago.

Chart 4: Value of invoice finance and asset-based lending advances



Source: UK Finance

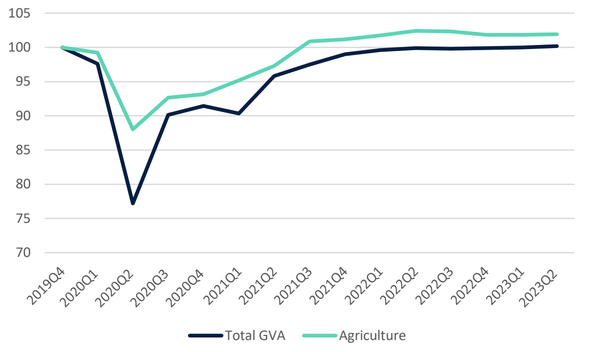
Note: IF/ABL data includes advances to client businesses of all sizes

SPOTLIGHT: AGRICULTURE

This is our first agriculture sector spotlight. For the purposes of this spotlight agriculture is defined as crop and animal production, hunting, and forestry. The lion's share of output (over 90 per cent) is accounted for by crop and animal production.

Chart 5 shows how output across the agriculture and forestry sector has evolved since the pandemic relative to the wider economy. The nature of the sector (including the reduced requirement for social distancing and essential production for consumers) meant that agriculture output declined less sharply at the start of the pandemic compared with other activities. And following the initial rebound, quarterly growth largely resumed its pre-pandemic trend.

Chart 6: Gross value added, 2019Q4 = 100



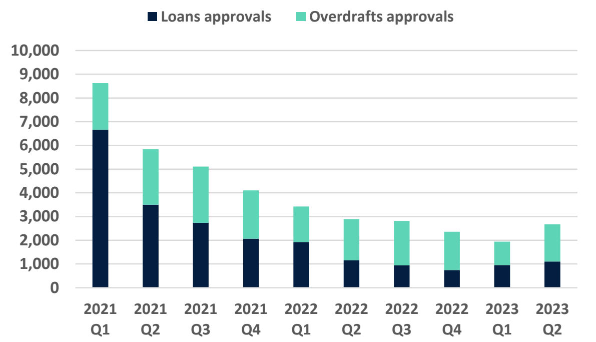
Source: ONS

The sector has some unique features, in terms of its seasonality and concentration in some UK regions. But in recent years has also seen challenges from post-Brexit trade development which have created a high degree of uncertainty about border arrangements and limited to supply of EU labour.

In addition, the industry has also been at the sharp end of cost pressures stemming from the Ukraine conflict with producers hit by rising energy, fertiliser and workforce costs, while being squeezed on selling prices by retailers. Overlaying this is the continuing need to improve efficiency and meet environmental obligations – all of which require ongoing investment.

Looking at the finance trends across the sector, our data ***chart 6*** shows trends in the volume and value of loan and overdraft approvals. The agriculture sector took the same advantage of government-backed loan support as other industries during 2020, with financing needs subsequently dropping back in subsequent years. The volume and value of finance approvals, like the rest of the economy, are still some way below pre-pandemic levels.

Chart 6: Number and Value of loan and overdraft approvals



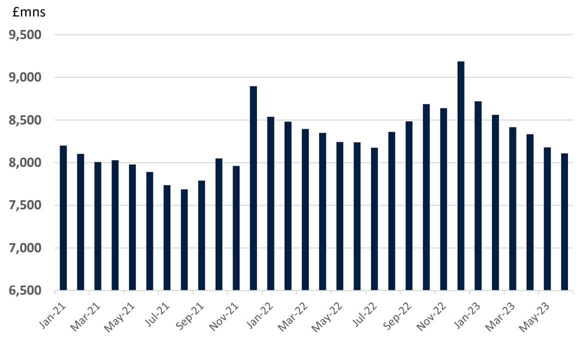
Source: UK Finance

Finance approvals to agriculture SMEs have been stronger than for other sectors over the first half of 2023. The post-mini budget rebound at the start of this year continued with another quarter of solid growth in the volume and value of approvals in the three months to June (up 26 per cent and 18 per cent respectively).

The top line on available deposits for SMEs in the sector is, again, not materially different from that in other sectors. At the end of 2023 Q2 total deposits stood some 25 per cent higher than at the end of 2020 Q1. However, the monthly profile is distinctively seasonal, with deposit levels peaking at year-end before they are depleted in the first six months of the year.

The evolution so far this year appears a little different from previous ones, although the pace of decumulation has been more rapid in the first half of this year compared with 2022 and 2021 – likely a reflection of the most intense input cost pressures highlighted in the introduction to this spotlight.

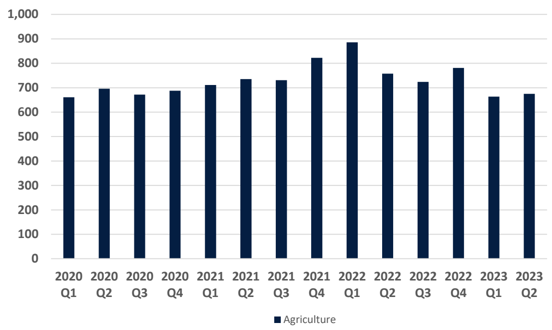
Chart 7: Deposits, £m



Source: UK Finance

Agriculture SMEs, again like those in the rest of the economy, are managing the repayment obligations of loans secured during the pandemic. ***Chart 8*** shows a similar repayment profile to that of the broader SME community, with a sharp increase in the value of repayments, post-Covid-19 and subsequent return to normal levels in the latter part of 2022. The most recent data points to a stable repayment profile in the first half of 2023.

Chart 8: Repayments, £m



Source: UK Finance

The outlook for the agriculture sector in the medium term holds both potential opportunities and challenges. The government's Food Strategy, which sets out the ambition to maintain current levels of production but with a focus on improving productivity. Alternate uses of land, for example for environmental and biodiversity benefits, may provide opportunities for farmers to monetise their land in a new way.

In addition, farmers in England are seeing their income from the Basic Payment Scheme reduce as EU subsidies are wound down, so finding ways to increase income though changes in production methods or though leveraging the net zero opportunity are important for the longer term outlook.

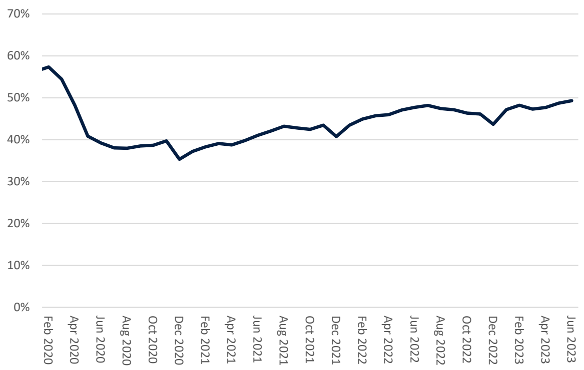
Financial headroom

The post-Covid-19 position for SMEs, in aggregate, has been one of a relatively good degree of flexibility within existing facilities and accumulated deposits. This position has not shifted materially in the past quarter.

However, recently we've noted some depletion of deposits, which utilisation of overdraft and IF/ABL facilities has been largely unchanged.

In the past three months, however, we have seen some gradual upward drift in overdraft utilisation rates – from an average of 45 per cent in 2022 in Q4 to 49 per cent in the most recent quarter (***chart 9***). While this is the highest since 2020 Q1, it is still well south of the 56 per cent seen immediately before the pandemic, suggesting that normal patterns of overdraft use are still some way off.

Chart 9: Overdraft utilisation, percentage

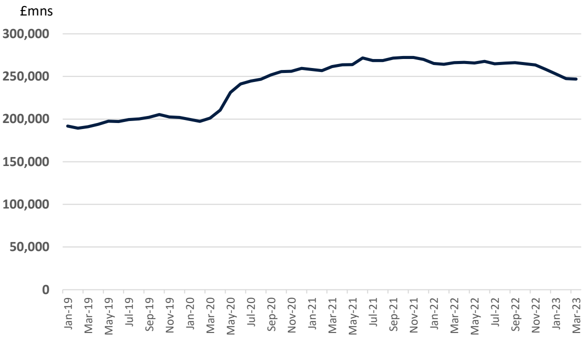


Source: UK Finance

Looking at sector trends in overdraft usage, most sectors have seen higher utilisation in the most recent quarter compared with the end of last year. There has been a particularly notable increase in accommodation and food services, and wholesale and retail, where utilisation rates have risen by nine and five percentage points respectively in the past six months. However, like the aggregate picture, there remains a greater degree of headroom in existing overdraft facilities in all sectors compared with the start of 2020.

In contrast (***chart 10***) shows an increase in deposits after two quarters of decline. Total SME deposits rose one per cent on the previous quarter. And mirroring the trends seen in personal deposits there was a further quarterly decline of three per cent in current account deposits, but a six per cent increase in notice accounts. Deposit account balances at the end of Q2 stood at their highest level since the end of 2021 as SMEs also took advantage of higher interest rates.

Chart 10: SME Deposits



Source: UK Finance

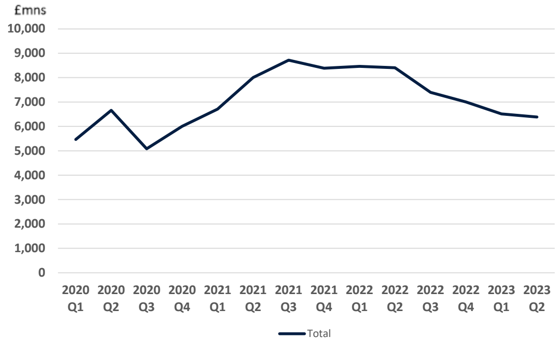
Looking at the sector breakdown of deposits, our data points to an overall rise in deposits in consumer facing sectors such as wholesale and retail, hospitality (up two per cent), and recreation and personal services (up over seven per cent). The gradual decumulation of savings seen in recent quarters continued across other industries.

Despite the variation across sectors, SMEs continue to have a fairly sizeable cushion of cash deposits at their disposal to navigate the weaker demand outlook in the coming year. Total deposits are still nearly a quarter higher compared with 2020 Q1. This tallies with the latest SME Finance Monitor findings, which showed that SMEs held the equivalent of 37 per cent of turnover in credit balances, up on the previous quarter and still above pre-pandemic levels.

Repayments

Finally, repayments are shown in ***chart 11***. Like most of the finance metrics this quarter, repayments were stable in Q2 at a little over £6.4 billion, fractionally down on the £6.5 billion of repayments in Q1. As shown in a previous review, the pace of decline of loan stocks on fixed rates continues to outpace that on variable rates as SMEs pay down government-backed loans acquired during the pandemic.

Chart 11: Value of repayments



Source: UK Finance

Outlook for SME finance

UK SMEs continue to face demand challenges from high inflation and soft consumer spending at home, with similar pressures weighing on the international outlook. While the consensus view amongst economists is that recession will be avoided, these challenges are unlikely to dissipate quickly.

Our latest data show that small and medium sized businesses continue to prudently manage their finances to navigate this stagnant demand environment – utilising existing facilities and diverting some deposits to secure higher returns – but plans for investment or other business development opportunities appear to be on the back burner. As such, demand for new loan finance has been muted.

With interest rates higher than SMEs have seen for more than a decade and risks to the growth outlook still present, the 'steady as it goes' picture of the first half of 2023 looks set to persist for at least the remainder of this year.

While we see that SMEs are managing their existing debt obligations, both in terms of their repayment behaviour and in survey data, there will inevitably be some cohorts that will be experiencing some difficulties. The banking sector remains well capitalised to respond to any adverse shocks and is ready to support both businesses concerned about their financial position and those with an appetite to invest for the future.

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