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 third quarter of 2023.

David Raw, Managing Director of Commercial Finance, comments:

"SMEs in all parts of the economy continue to face a challenging outlook. Input cost pressures may be easing but demand looks set to remain weak in the near term.

"Our data suggests that SMEs are leaning more heavily on existing resources, particularly cash deposits, rather than seeking new finance. The higher interest rate environment will also be suppressing firm's appetite to borrow.

"A stronger demand outlook is ultimately what SMEs need to be confident to make investment decisions for future growth. And the chancellor's recent announcement on 'full expensing' of investment will provide an added boost for future plans.

"Lenders are ready to lend to those businesses that need it to navigate current challenges and for future growth plans. They stand ready to support any SMEs concerned about their financial obligations."

2023 Q3 HIGHLIGHTS

- **Gross lending by the main high street banks was stable but subdued in Q3, in line with survey indicators of demand.**
- **Overdraft approval volumes continue to trend higher than loan approvals.**
- **Weakening finance approval volumes in most industry sectors.**
- **IF/ABL client numbers steady but advances continued to drift lower.**
- **Overdraft utilisation remains broadly unchanged again over the third quarter.**
- **Decline in SME deposits resumes, but levels continue to be higher than pre-Covid.**
- **Repayments have been stable across 2023 to date as SMEs continue to meet repayment obligations.**

Company number: 10250295.
Registered address: UK Finance Limited, 1 Angel Court, London, EC2R 7HJ

Economic outlook

The UK economy flatlined in the third quarter with the Office for National Statistics (ONS) indicating that GDP was unchanged in the three months to September compared with the previous three months.

A 0.1 per cent fall in services output was the main drag on growth over the quarter, with modest growth (0.1 per cent) in both construction and manufacturing. This was the first quarterly contraction in the service sector since 2021 Q1.

The impact of industrial action had a particular impact on services in July, driving an overall contraction in services of 0.5 per cent on the month. However, weakness was more widespread, with ONS signalling a challenging quarter for consumer-facing services, which includes hospitality, retail, and recreation activities.

This speaks to the continuing pressure on household budgets from high inflation and rising mortgage rates. Consumer confidence has been fragile throughout this year, with a diminished appetite for major purchases and discretionary areas of spending. While wage growth has accelerated, the squeeze on real disposable incomes is forecast by the Office for Budget Responsibility (OBR) to continue, constraining demand in the near term.

The news was somewhat better in manufacturing and construction sectors, both of which expanded in the third quarter. However, Q3 marks a low point for growth across both industries compared with a more buoyant picture over the past year.

A more subdued export demand picture is adding to the headwinds facing manufacturing. Higher interest rates and the weaker housing market has left construction firms relying on repair and maintenance activity to support activity.

The backdrop of weaker demand, flagging business confidence, and higher borrowing costs has resulted in a contraction in business investment in the third quarter. Investment fell by an estimated four per cent compared with the previous three months, more than reversing the gains in Q2. This weakness will be among the factors holding back demand for finance, which we will turn to in the next section.

The UK's relatively poor investment performance contributes to a similarly poor productivity performance and unlocking more capital investment has long been a priority for policy makers. Important not just for improving productivity and international competitiveness, but higher investment will also be necessary in the drive for net zero.

In what will hopefully end the churn of temporary measures to try and kick start greater investment, one of the biggest spending announcements in the autumn statement was the decision to make full expensing of capital investment permanent.

While this will not move the dial on business investment in the near term (indeed the Office for Budget Responsibility expect business investment to contract next year) it should provide businesses with more confidence and stability in tax system to make long term investment decisions.

The softer demand outlook has also led to a fall in the demand for workers. The number of vacancies in the economy fell again in the Q3 (though levels are nevertheless higher than pre-Covid). However, ONS estimates that unemployment has remained low at 4.2 per cent in the most recent quarter. But wage growth is still running hotter than monetary policy makers would like, with earning growing at an annual rate of nearly eight per cent, indicating the labour market remains tight and it presents a potential upside risk for inflation.

CPI inflation has, however, dropped back to 4.6 per cent in October as energy prices fell out of the annual series, but core inflation was still elevated at 5.7 per cent (down from 6.1 per cent in September). This is welcome news for households and for businesses, which are also reporting an easing in cost pressures. It was also in line with Bank of England forecasts. However, those forecasts also point to its two per cent target not being met until 2025.

At its most recent meeting in November, the Monetary Policy Committee (MPC) continued to hold Bank Rate at 5.25 per cent. The decision was again split with three members voting for a quarter point rise. Communications from MPC members have been keen to stress that risks to the inflation outlook remain, including from higher food and energy prices. It is, therefore, too soon for any discussion about the timing of future interest rates cuts.

Notable in the Bank's November forecast was the downgrade to GDP growth next year. No growth is expected in 2024. The OBR also made a large downward revision to its 2024 growth forecast, while not quite as downbeat as the Bank, its forecast of 0.7 per cent next year points to continuing pressures on activity in the near term.

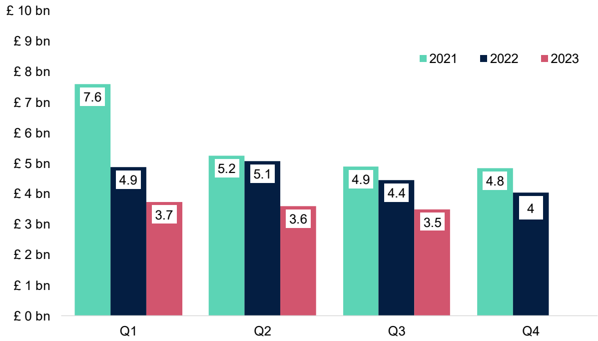
From a small business perspective, recent data have pointed to a pickup in insolvencies through this year, particularly in sectors such as hospitality and construction. While the SME sector has proven to be resilient, there are clearly continuing headwinds in the year ahead and optimism about future prospects remains muted.

SME finance

In previous Business Finance Reviews covering the first half of this year we noted the weaker path of gross lending by the main high street banks to SMEs compared with that reported in 2022. Our latest data shows more of the same for the third quarter, with the value of gross lending broadly stable compared with the first half of 2023, at £3.5 billion.

The Q3 data does, nevertheless, represent the fifth consecutive quarter of decline (***chart 1***). Comparing with the same period last year gross lending is down by just over a fifth. Figures from the Bank of England, which provide a more complete picture of the SME lending market, show a slightly less rapid, but still significant 16 per cent year-on-year fall in new lending.

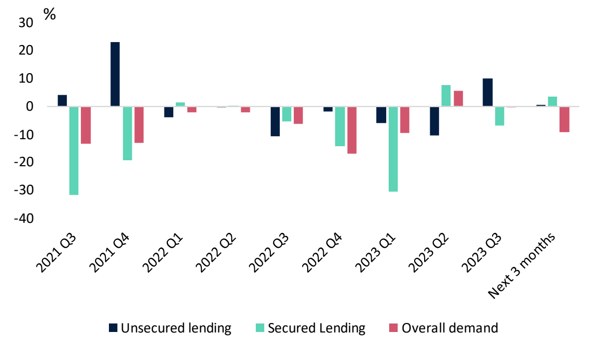
Chart 1: Gross lending to SMEs



Source: UK Finance

Factors such as demand uncertainty, higher interest rates and, for some SMEs, the overhang of lending taken out during the pandemic, are all contributing to the weakness in gross lending over the course of this year. Indeed, the Bank of England credit conditions survey (***chart 2***) shows that overall demand for credit from SMEs was flat in Q2, with a further contraction expected in the final quarter of 2023.

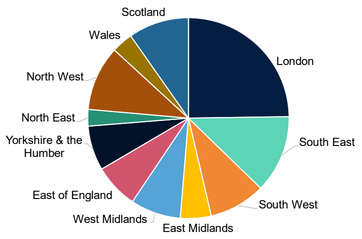
Chart 2: Demand for lending from small businesses, net percentage balance



Source: Bank of England

Chart 3 illustrates that gross lending to regions in Great Britain continues to align with the distribution of the business population. Due to some reporting changes by data submitters[1] Q3 data is not directly comparable with the previous periods so it is not possible to draw conclusions about trends in lending across regions in the most recent quarter.

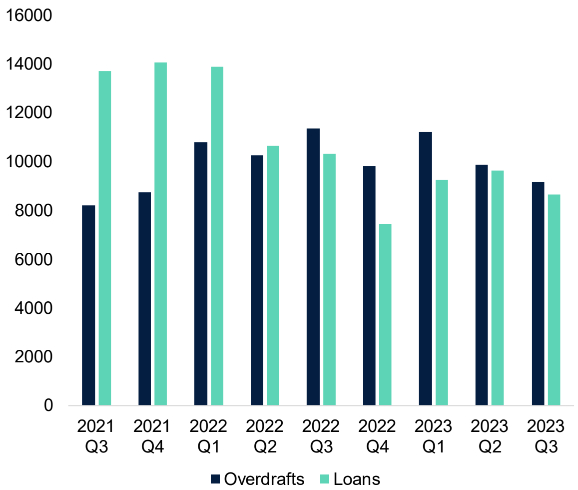
Chart 3: Gross lending by region



Source: UK Finance

Turning now to finance applications approved in Q3, the trend of a higher volume of overdraft approvals compared with loans that has been evident since 2022 Q3 persisted in the three months to September. However, there has been a steady drop in overdraft approval numbers over the past year.

Chart 4: Number of approved loans and overdrafts

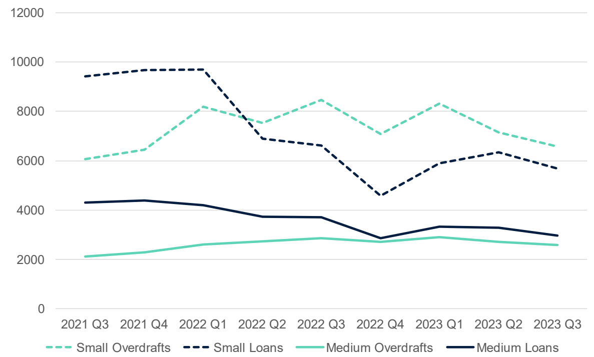


Source: UK Finance

This may be a result of the easing in input cost pressures, highlighted in the introduction, reducing the requirement for cashflow finance, compared with peaks last year, together with the increased costs of finance as interest rates have risen. SMEs may also be leaning more on available cash deposits (which we will cover in a later section), rather than taking on new finance.

As ***chart 5*** shows, the drop in overdraft approvals has been particularly notable amongst the smallest businesses. This drop in approvals takes volumes back towards levels seen during the pandemic, when small businesses were drawing more on government-back loans rather than commercially provided forms of finance.

Chart 5: Number of approved loans and overdrafts by size



Source: UK Finance

The total volume of loans approved also eased back last quarter, after a modest uptick in the previous quarter. Despite this quarter's decline the total number of loans approved was still higher than that seen in 2022 Q4 when demand fell sharply with the market turmoil of the mini-budget. Again, ***chart 5*** shows that small businesses were also behind the drop in loan approvals with more stability across volumes for medium businesses.

In addition to business size, industry sector can also be an important driver of finance applications and approvals. ***Chart 6*** illustrates combined loan and overdraft approvals for the

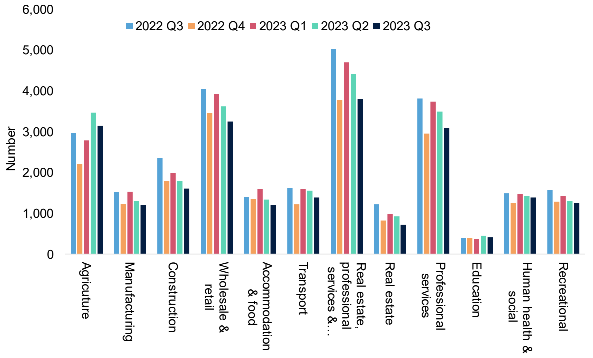
[1] Note: From time to time lenders will make changes to their internal systems and processes which will lead to a break in the data series, meaning that data is not comparable with previous periods. In 2023 Q2 and Q3 we have had two such changes which should lead to improved reporting on regional breakdowns of lending.

main sectors covered and the declining trend over the quarter seen in the aggregate data in ***chart 4*** is replicated across all sectors.

This would align with the broader challenges of the fragile demand outlook and higher borrowing costs rather any specific sectoral factor pushing down on demand and approvals.

One outlier, however, is real estate which recorded the latest declines in loan and overdraft approvals – perhaps one of the sectors most sensitive to higher interest rates. Outside of this, there was little to separate the pace of decline across other industries.

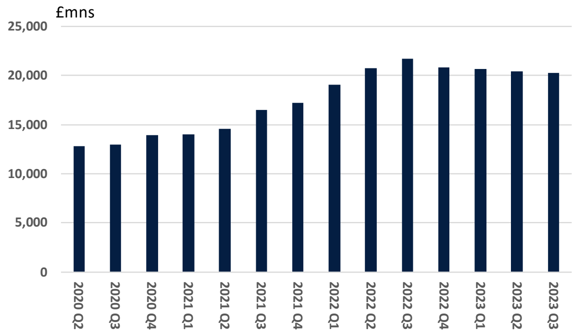
Chart 6: Number of approved loans and overdrafts by size



Source: UK Finance

Looking at the final finance product in our series, invoice finance and asset-based lending (IF/ABL), overall we observe a similar trajectory to other forms of finance.

Chart 7: Value of invoice finance and asset-based lending advances



Source: UK Finance

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

Total client numbers, which have been hovering around the 34,900 mark in each quarter of the past year, were largely unchanged in 2023 Q3. As noted in previous BFRs, Q4 2022 had seen a record in client turnover (IF/ABL members supported sales of £82 billion during that period), with turnover since drifting down from that peak. Nonetheless, it appears that 2023 is on track to potentially match 2022's record of £314 billion of client sales supported by the sector.

Reflecting the trends seen in other types of lending, IF/ABL advances overall continued to drift down for the fourth quarter running, following a robust run of growth as the economy emerged from the pandemic (***chart 7***). Our data does, however, point to clients retaining a good deal of headroom within existing IF/ABL facilities, with total funding available of £33.5 billion (another record), with utilisation falling to 60 per cent for the third quarter.

Finance and ethnic minority business

UK Finance and the industry supports the BVA BRDC SME Finance Monitor. December 2023 saw the publication of a deep dive into the finance needs and attitudes of ethnic minority businesses (EMBs).

As we've noted, demand at the aggregate level has been relatively depressed for much of the past year, while it is important to consider regional and sectoral development in this context, it is also important for industry to understand how different cohorts of SME are managing their businesses and their finance support needs.

The latest report, which can be found here, shows:

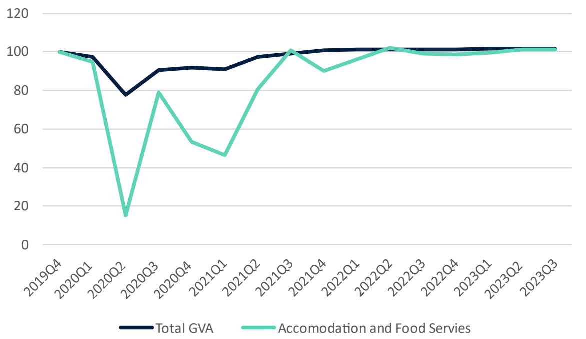
- EMBs are typically younger and smaller than SMEs overall.
- EMBs are more likely to be planning to grow, trading internationally and prepared to take risks.
- However, current performance indicators suggest that EMBs are more likely to describe themselves as struggling and less likely to have made a profit in the past year.
- There appears to be no difference in EMBs using traditional forms of external finance, relative to peers, but higher levels of concern about managing repayments.
- Looking ahead EMBs are more likely to be planning to apply for finance but are less confident about being successful in securing it.

SPOTLIGHT: ACCOMMODATION & FOOD SERVICE ACTIVITIES

Against a broadly stable picture for SME finances this quarter, there are, nevertheless, a few indicators where the accommodation and food services sector stand out. So, this quarter we'll take another look at specific developments in the industry.

Starting with the recent performance of firms in the sector, output growth was exactly in line with the wider economy – that is unchanged from the previous quarter. Prior to that however, the accommodation and food sector had a considerably stronger first half of 2023 than seen in the whole economy (***chart 8***). While consumer budgets have been under pressure resulting in some aspects of discretionary spending being pared back, UK Finance's household finance date has shown resilience in spending on travel and hotels, which has continued to support the sector.

Chart 8: Gross value added, 2019Q4 = 100



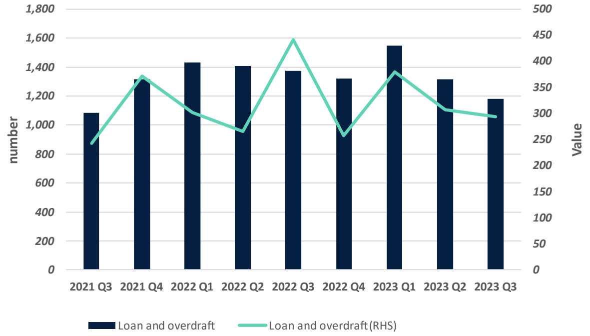
Source: ONS

Key concerns of the sector, according to the ONS business insights and conditions survey (BICS), remain energy prices and inflation, however, the proportion of firms highlighting these as business concerns has been heading lower since the start of this year.

While the number of vacancies in the sector have reduced in line with other sectors, accommodation and food services businesses are still facing some of the most acute recruitment difficulties. In addition to concerns about getting the right skills, there has also been an increase in concern about business rates and taxation, though some of these may have been addressed, to a degree, by measures announced in the recent autumn statement.

The value of loans and overdrafts approved to accommodation and food SMEs fell sharply last autumn, but recovered at the start of 2023. Subsequently, both volume and value of applications has trended lower, though the latter is still higher than the 2022 Q4 trough.

Chart 9: Number and Value of loan and overdraft approvals



Source: UK Finance

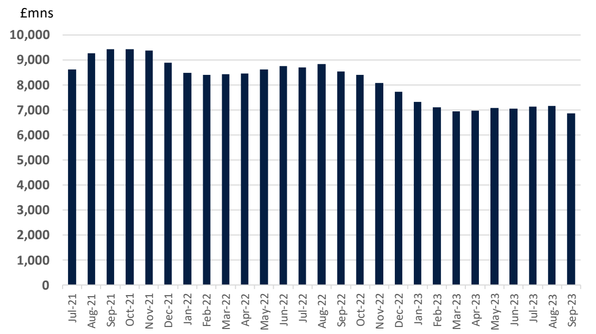
Following the end of the Covid-loan schemes demand for overdraft finance from businesses in this sector recovered strongly (as was the case in the wide SME population). Our data shows growth in overdraft approvals in every quarter from the start of 2022, likely in response to large increases in input and staffing costs. Growth came to a halt last quarter and in Q3 overdraft approvals fell by a further 12 per cent. However, utilisation of overdrafts has increased quite materially over the past year in this sector, and to a much greater degree than seen in the wider population.

Loan approvals have been more variable over this period, falling through 2022, but with some growth in the volumes in the first half of 2023. In Q3 approval numbers fell by nine per cent.

One of the standout difference between SMEs in accommodation and food services and the rest of the economy is the pace at which they have drawn down accrued deposits. In the second half of 2022, deposits in this sector fell by 12 per cent compared with a fall of just over three per cent in the whole SME population in GB.

There was a similarly rapid pace of decumulation in 2023 H1 (nine per cent compared with four per cent for all SMEs). This difference would be consistent with the relatively greater cost pressures facing a sector challenged to pass on those increases in an environment of fragile consumer confidence and demand. In the most recent three months the fall in accommodation and food services deposits has slowed compared with the rest of the economy.

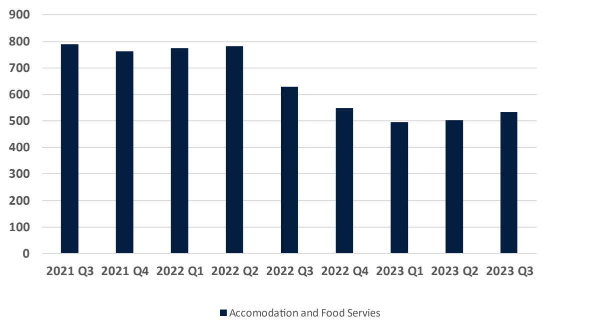
Chart 10: Deposits, £m



Source: UK Finance

Finally turning to repayments, the accommodation and food services sector is very much following the national trend with stability in the level of repayments in each quarter over the past year.

Chart 11: Repayments, £m



Source: UK Finance

While there have been particularly challenges facing this sector, SMEs have continued to manage their existing debt obligations. The latest indications from the ONS BICS points to levels of confidence about meeting ongoing obligations holding up through 2023, with nearly three in five very or moderately confident. However, this is lower than confidence levels reported a year ago.

Looking ahead, the strength of consumer demand and confidence will be key to the growth outlook for the sector. And with real income growth recovering only slowly next year, this will provide an ongoing challenge for SMEs in the accommodation and food services sector.

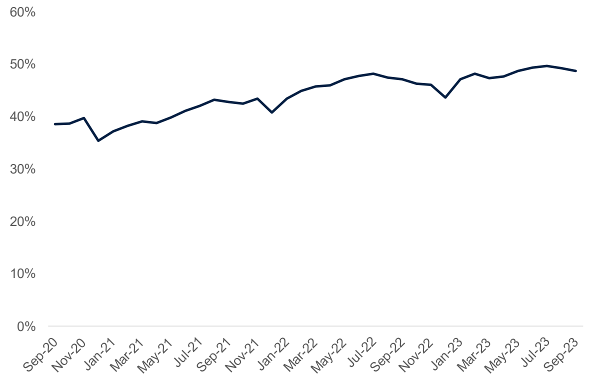
Businesses will also be alive to further movements in input costs following last year's energy price shock. Climate change and the impact of food shortages, for example, present a further risk to the outlook.
SMEs in this sector have taken on new finance, primarily new overdrafts to manage cashflow challenges and have deployed headroom within existing facilities and deposits to navigate recent cost pressures. While the aggregate picture on the availability of deposits continue to look relatively healthy, there will inevitably be some businesses whose flexibility to manage any further challenges has been significantly eroded.

Autumn statement announcements on business rates – to freeze the multiplier and extend the Retail, Hospitality and Leisure (RHL) scheme, will provide some helpful support for the sector.

Financial headroom

Turning to the available of finance within existing facilities and cash deposits, we firstly see a stable picture on overdraft utilisation in ***chart 12***. While we see a little volatility from month to month over the quarter the average utilisation rate, of 49 per cent, was unmoved from the previous quarter. And looking in more detail at utilisation across SMEs of different sizes and in different sectors, the story of stability is a consistent one.

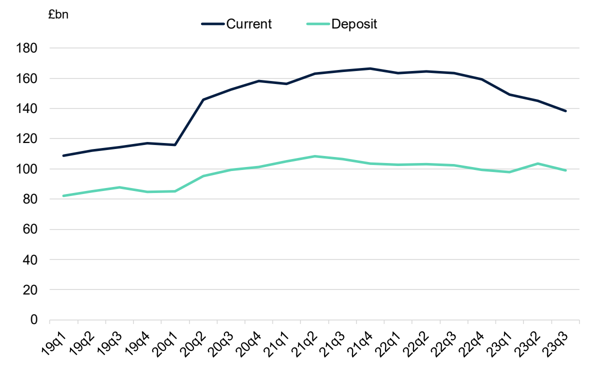
Chart 12: Overdraft utilisation, percentage



Source: UK Finance

While usage of overdrafts has moved little in the most recent period, there has been an upward drift in utilisation rates over the past year. The biggest movers have been in accommodation in food services, which overdraft use has increased from 31 per cent in 2022 Q3 to 42 per cent in 2023 Q2, and in wholesale and retail where rates were 40 per cent and 45 per cent respectively.

Chart 13: SME Deposits



Source: UK Finance

As noted earlier, a factor that might be limiting demand for new finance is the availability of a still significant stock of cash deposits. Our latest data does signal that SMEs were drawing on these to a greater degree that we saw in the previous quarter. It does appear a prudent approach for businesses to adopt this strategy to manage day to day costs rather than take on relatively more expensive new finance.

Chart 13 shows that total deposits fell 4.5 per cent on the quarter after modest uptick last quarter. This quarter we note the pace of decline was consistent across current and deposit accounts, in contrast to Q2 when there was a notable increase in deposit accounts. However, both current and deposit account balances remain significant up on pre-Covid levels (19 per cent and 16 per cent respectively).

In line with many of the other metrics reported on in the review, over the past year decumulation of deposits has taken place at a similar rate across small- and medium-sized businesses.

Fall over the quarter and compared with a year ago were seen across all sectors, but most rapid run down over the past year has been in hospitality, and real estate and professional services.

Repayments

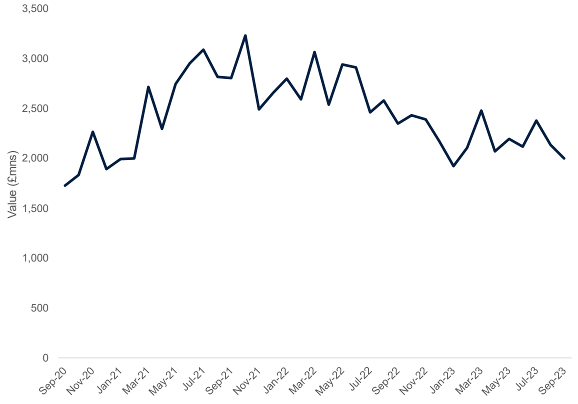
This relatively stable profile is apparent in all sectors.

At the end of Q3 the stock of fixed lending was 16% lower on a year earlier; variable lending stock down 8%.

Finally, we turn to repayments. ***Chart 14*** suggests a volatile monthly profile of SME repayments, but looking through this we find that on average repayments have been running at an average of £2.1 billion per month through 2023. And we note no material movement from this average repayment through the third quarter of the year.

The sector path of repayments followed the national trend across the quarter, suggesting that the aggregate picture remain one of SMEs continuing to be able to meet their repayment obligations. This continued to be particularly true of the Covid-lending schemes as the stock of fixed lending was down 16 per cent on a year earlier, and variable loan stocks eight per cent down over the same period.

Chart 14: Value of repayments



Source: UK Finance

Outlook for SME finance

Our latest review points to a fairly stable picture for SME finances, but demand for finance has nevertheless been stagnant this year. Businesses are being understandably cautious about taking on new finance, opting to use existing resources to meet finance needs.

We don't expect this picture to change significantly in the coming quarters. Until businesses see a clearer path to a stronger and more certain recovery, they are unlikely to be focused on longer term investment and expansion. They will also be aware of the risk of further price shocks, which could erode any remaining cushion SMEs have available.

As we continually observe, SMEs are resilient and have survived through a series of significant shocks in recent years. Lenders recognise that resilience and are ready to support investment plans or help SMEs manage financial turbulence and any business facing difficulties is strongly encouraged to engage early with their lender.