UK Finance

Business Finance Review 2024 Q2

Quarterly commentary on business finance for small and medium-sized enterprises.

September | 2024

2024 Q2 Highlights

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 second quarter of 2024.

Executive Summary

- The UK economy continued to recover from the mild recession at the end of last year and surveys indicate improving sentiment across all business sectors going into the second half of 2024. While we have seen a notable uptick in insolvencies, as a share of businesses these remain lower than in the 2008/9 downturn. Nevertheless, this will remain an important metric to watch as the economy continues to recover,
- Gross lending in the three months to June was up year-on-year for the second quarter running. While encouraging at the aggregate level, the picture remains uneven across sectors and regions. Moreover, net lending by the main high steet banks remains in negative territory, particularly so for the smallest SMEs, and it may yet be some time before this returns to pre-pandemic norms.
- However, further increases in new lending could be in prospect as the volume of new finance approvals continued to rise in Q2 compared with a year ago. The gradually improving trend is consistent across sectors, indicating a more broad-based rise in demand for finance as the economic outlook improves and further cuts in interest rates are in prospect. Again, however, the volume and value of finance approvals remains below that reported in the run up to the pandemic.
- SMEs continued to run down deposits over the quarter, but at a slightly slower pace than seen over the previous year. Overall, SMEs continue to have a good degree of headroom in their cash deposits, but some sectors are now seeing the deposits accumulated during the pandemic dwindle. Similarly, utilisation of existing finance arrangements, such as overdrafts, remains broadly stable, further offering some flexibility to SMEs.
- The trend in finance repayments remains broadly stable as SMEs continue to meet repayment obligations, particularly Covid loans. The value of repayments is running at pre-pandemic levels, a trend we expect to continue as SMEs continue to pay down pandemic funding and some prioritise this over taking on new finance for business development.

Economic context

The UK economy posted another solid quarter of growth in the three months to June. GDP rose by 0.6 per cent in Q2, following a 0.7 per cent expansion in the first quarter. This represents a stronger than expected performance following the mild recession at the end of 2023.

The monthly profile of growth over the quarter was bumpy, with expansion only recorded in May. The picture was not entirely rosy across all parts of the economy. Services did almost all the heavy lifting in Q2, expanding by 0.8 per cent, and within that, growth was widespread across sub-sectors. This makes the first half of 2024 the strongest six months for services since H1 2022.

Within services, the picture was weaker for consumer-facing sectors, which fell 0.1 per cent. In part reflecting cautious consumers still burdened by the recent period of high inflation and rising interest rates. And the disappointing wet start to the summer, which impacted retail sales.

Manufacturing output, on the other hand, contracted by 0.6 per cent following decent growth at the start of the year. Transport equipment was a drag on the headline manufacturing numbers, although not entirely unexpected as automakers were making changes for production lines for new models, particularly electric vehicles. The poor run of construction data continued, with output falling for the third quarter running. While the pace of contraction slowed to 0.1 per cent, the order outlook continues to look fragile.

Business sentiment indicators through the second quarter and into the third, have been signalling some improvement in activity. Purchasing managers' indices for manufacturing, services and construction were all in positive territory in June and July. Nevertheless, the data is not showing clear signs of strong underlying momentum. In its latest forecast update, the Bank of England expects quarterly growth to moderate in the second half of the year.

A couple of factors support this view. The first is sentiment amongst domestic consumers, while creeping, it remains fragile. Real incomes will only recover gradually and even though labour market conditions are favourable, spending is still subdued.

Secondly, international indicators, particularly in Europe, have come in weaker than expected. The German economy contracted in Q2, with little sign of much momentum elsewhere in the region. There are also concerns about the health of the US economy, but thus far the data isn't pointing to a looming recession. In any case, there is not likely to be much support coming from overseas demand.

While many activity indicators are heading in the right direction, recent insolvency data highlight the fragile nature of recovery for some firms and sectors. According to the Insolvency Service, company insolvencies in June were up 17 per cent on the year previously, and the third highest number since the series began.

A relatively high number of insolvencies in the construction sector has been evident in the data in recent quarters. In addition, there have also been sharp increases in accommodation and food services. These sectors have been particularly exposed to rising costs, (including wages and rents in hospitality) as well as weakening demand. However, the rise in insolvencies generally, should be seen in the context of the rise in the business population. Insolvencies per 10,000 companies remain well below that seen during the financial crisis.

A further indicator of business activity and optimism is recruitment. The number of vacancies in the economy has fallen steadily over the past two years, though remain higher than immediately before the pandemic. In addition, hiring intentions, as reported in business surveys is muted.

These signs of loosening in the labour market, as well as the moderation in consumer price inflation, has been welcome news to monetary policy makers. In its August meeting, the Monetary Policy Committee (MPC) voted, narrowly, to reduce Bank Rate by 25 basis points, to five per cent. For some, the decision was still a finely balanced one. And four of the nine members, still wanted to see more evidence that second round effects on inflation from elevated wage growth were dissipating and that inflation was on a sustainable path back to target.

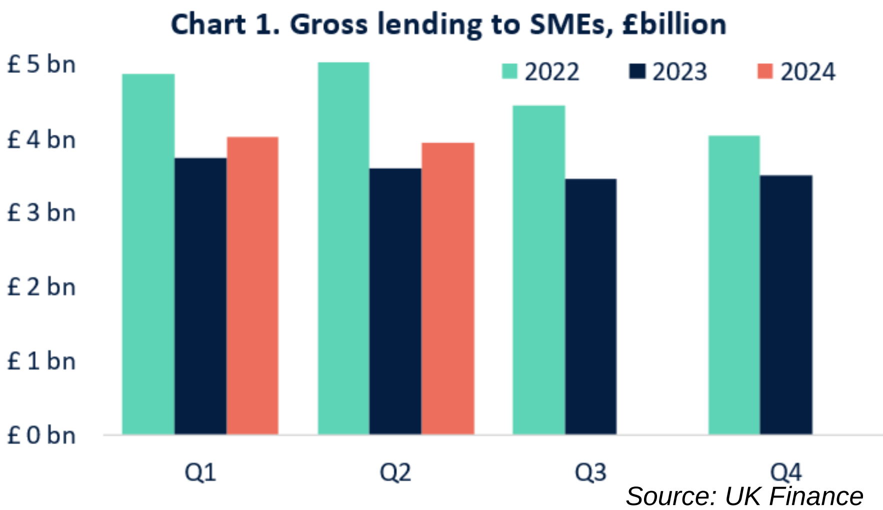
There is unlikely to be a lot of new news ahead of the September meeting and the Bank's Market Participants Survey shows that economists expect one more rate cut this year, in November.

Beyond that, the next significant policy announcement will come from the new government, when it announces its first Budget at the end of October. With constrained public finances and manifesto commitments not to increase a range of key taxes, businesses will be looking at the detail on measures on infrastructure and investment, which may benefit the supply chain, and potential on action business rates.

Lending to SMEs

In the first three months of 2024 our data showed year-on-year growth in gross lending by the main high street banks for the first time since the pandemic. In the second quarter of the year, overall gross lending was broadly stable at £4 billion, but again higher than a year previously (**chart 1**).

While this improvement in lending is over a relatively short timeframe, it does, perhaps, signal a turning point from the prolonged period of declining lending seen after the pandemic and through more recent challenges of stuttering economic recovery, rising interest rates and elevated cost pressures.



Source: UK Finance

This gradual recovery in new lending coincides with the annual growth in loan approvals to SMEs seen since the final months of 2023, and which also continued in the most recent quarter.

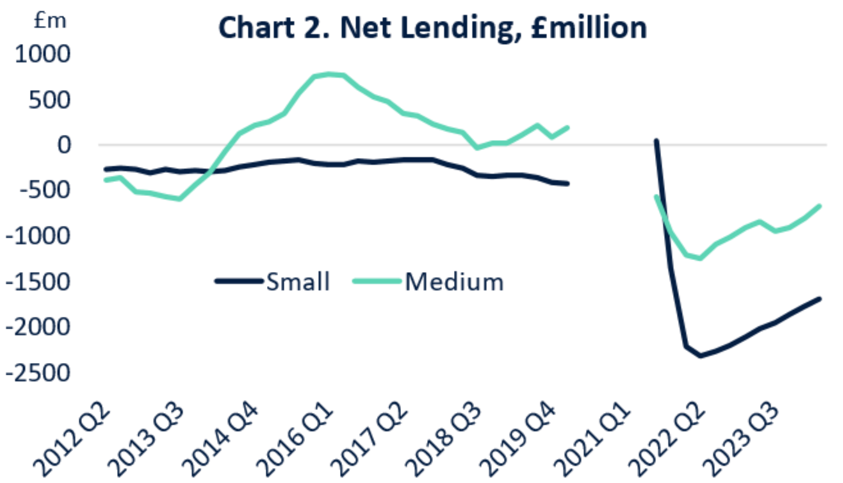
Growth in lending over the first half of this year relative to the previous one was not, however, universal across all sectors or regions. Regional lending growth was strongest in the East Midlands and North West, but the only regional to post a decline was Yorkshire and Humberside.

Sectoral variation was more pronounced, with notable expansion in lending to SMEs in agriculture, construction, and real estate. But at the other end of the spectrum lending in H1 2024 was down year-on-year to manufacturers and SMEs in transport, storage, and communications.

While the aggregate trends in lending are positive in the context of recent years, quarterly gross lending levels remain below that seen prior to the pandemic. Perhaps a starker indication of current SME finance trends relative to 'normal' is the path of net lending (gross lending minus repayments, **chart 2**). The chart illustrates four quarter average levels of net lending excluding the Covid period, when government backed loans led to a significant expansion of lending.

Post-pandemic, net lending fell very sharply across SMEs, but particularly so for the smallest ones, as business borrowing slowed, and repayments of government backed BBLS and CBLS loans fell due.

Evidence from the SME Finance Monitor, for example, showed that the proportion of SMEs reporting any need for finance (whether they applied or not) halved in 2022 compared with 2021 (from 12 per cent to six per cent) and fell further (to four per cent) in 2023. This trend was consistent across SMEs in all size brackets. At the same time as demand for new finance fell, repayments rose sharply, with a minority of SMEs fully repaying Bounceback loans when the interest-free period concluded.



Source: UK Finance

With subdued finance demand and lending activity, until the most recent quarters, net lending remains firmly negative and heading only slowly back to balance.

This is in sharp contrast to trends seen pre-2020.

Post-financial crisis net lending to SMEs with a turnover over £2 million recovered and largely remained positive until the pandemic, though some of the weakening through 2017 may have been, in part, due to Brexit uncertainty.

Net lending to the smaller end of the SME spectrum has been in negative territory throughout our data series. In addition to the factors outlined above explaining recent trends, this may also reflect new entrants into the market challenging the main high street banks. Also significant is survey evidence from the Bank of England[1] which shows that three-quarters of businesses agreed with the statement *'I would like my business to pay down debt/be debt free'.*

For those SMEs with outstanding Covid loans, repayments are set to continue for around another four years. If this aim to become debt free takes priority over taking

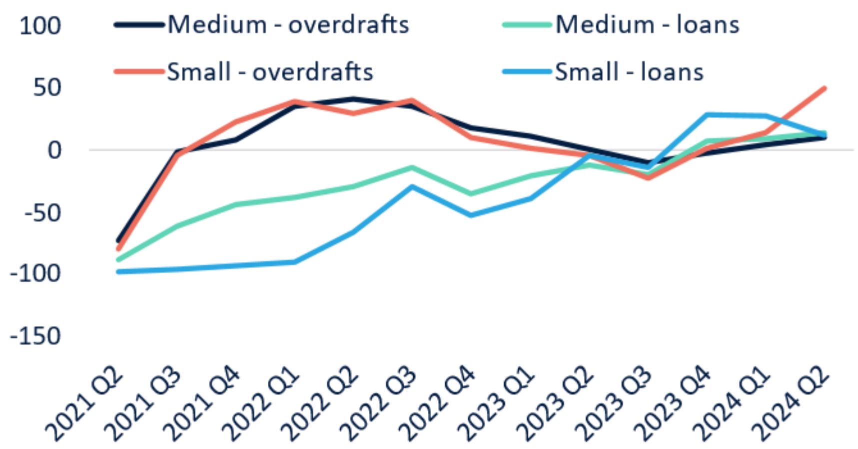
[1] https://www.bankofengland.co.uk/quarterly-bulletin/2024/2024/identifying-barriers-to-productive-investment-and-external-finance-a-survey-of-uk-smes

on new finance for investment or business development, it will likely be some time before net lending returns to positive territory.

New finance approvals

Our data has indicated several quarters of growth in new finance approvals for both loans and overdrafts (**chart 3**). Post-pandemic there was something of a rebound in overdraft approvals, which had previously fallen away sharply when Covid lending schemes were introduced.

Chart 3. Finance approvals, percentage change



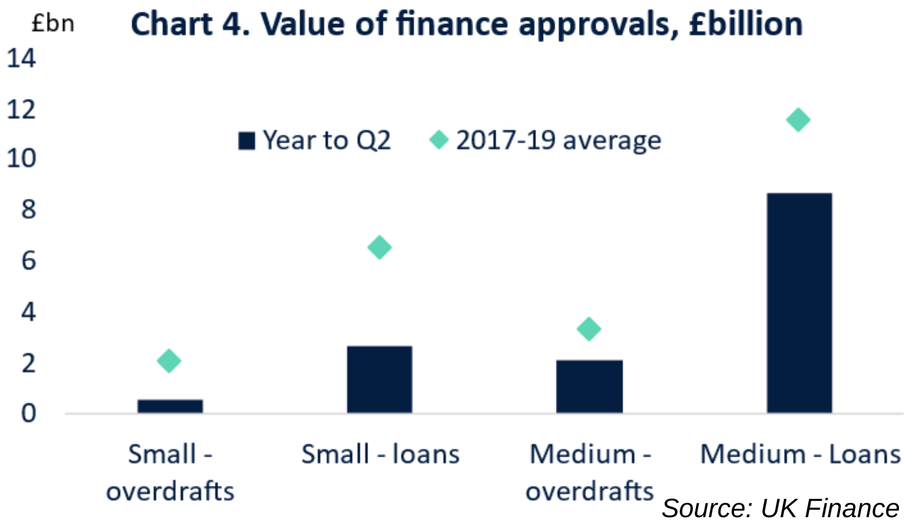
Source: UK Finance

Soaring input costs through 2022 and 2023 further spurred demand for working capital facilities across both small and medium-sized SMEs. In contrast, loan approvals continued to contract in response to a fragile economic outlook and rising interest rates.

The past three quarters have seen a modest recovery in the number of loans approved, compared with the same period a year ago – a trend not seen since the pandemic. This positive trend is also seen across both small and medium-sized businesses.

This chimes with recent evidence from the SME Finance Monitor, which has shown a steady increase in the proportion of SMEs planning to apply for finance. In 2024 Q1, the most recent data, the proportion of businesses planning to apply had risen close to pre-pandemic levels for all but the larger SMEs. However, the SME Finance Monitor does not indicate a timeframe for those applications. Indeed, the Bank of England Credit Conditions survey paint a pretty stagnant demand picture for finance across business of all firm sizes in recent quarter, with more of the same expected going into the second half of 2024.

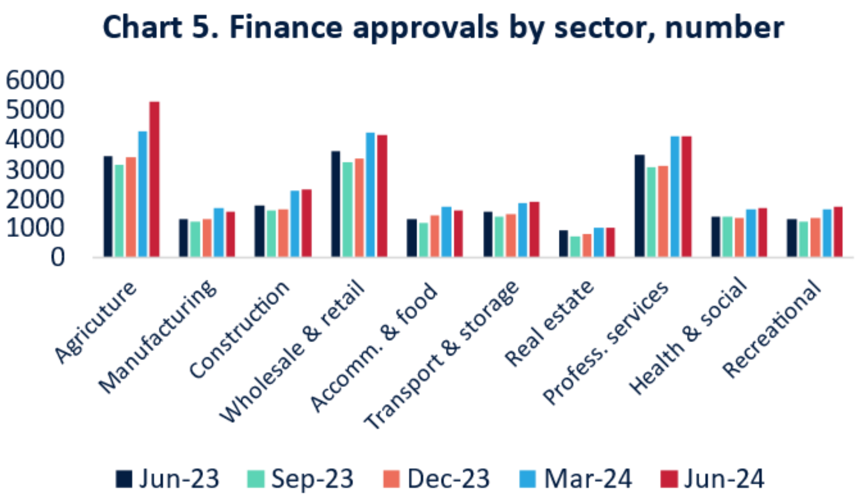
Echoing the 'far from normal' trend in overall gross lending, the value of new finance approvals also continues to lag that recorded in the years before the pandemic. Overall, overdraft and loan approvals in the year to 2024 Q2 were running at around half and three-fifths respectively of the 2017-19 average. And as **chart 4** illustrates the gap is more significant for smaller companies.



Source: UK Finance

Looking at sector trends in finance approvals, **chart 5** shows a very consistent trend across all parts of the economy, with a steady rise in the number of finance approvals in the first half of 2024. Across all sectors approval volumes in Q2 were up on the same quarter a year ago.

Despite the bumpier recovery of some sectors seen in the official data, and discussed at the start of this Review, business sentiment is, nevertheless, gradually improving.

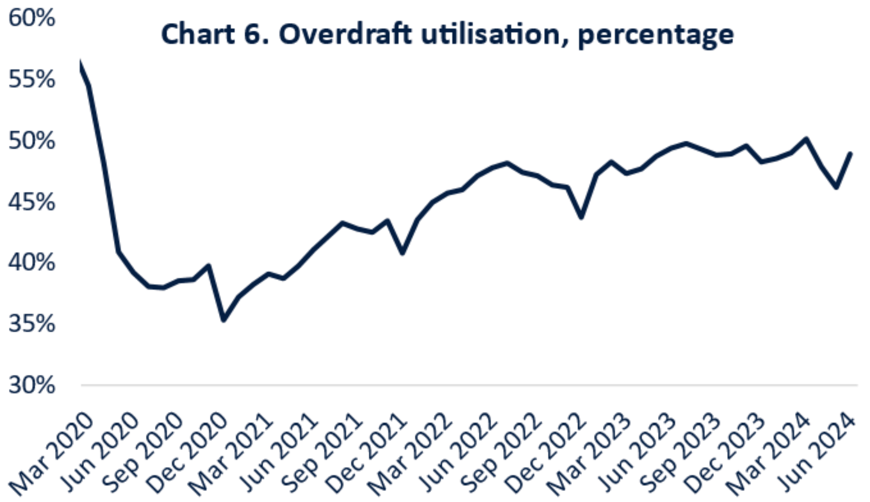


Source: UK Finance

If we see a tangible and broad-based recovery in trading conditions, alongside further reductions in Bank Rate, further growth in approvals should be expected. However, as mentioned, this will need to be sustained for some time to return to pre-pandemic norms.

Utilisation of existing facilities

While we have seen some increase in the provision of new overdraft facilities this year, utilisation of those facilities has been fairly stable over the same period. The average overdraft utilisation rate over the quarter was 48 per cent (**chart 6**), little changed from the previous quarter and still well below the rate seen at the start of 2020.



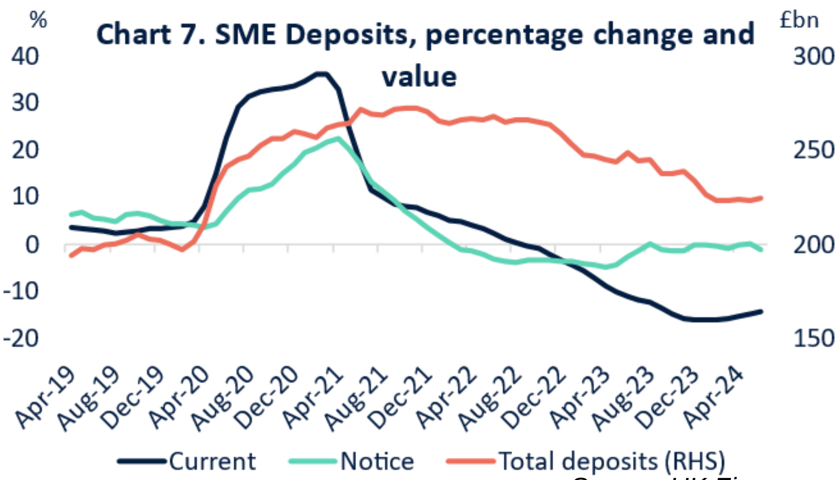
Source: UK Finance

Last quarter we noted a significant increase in overdraft utilisation across some consumer-facing sectors, notably accommodation and food, and recreation and personal services. Across both sectors, this trend entirely reversed in Q2, as seasonal pressures requiring hospitality and recreation SMEs to use more of their overdraft buffers waned.

In contrast, we see the usual Q2 uptick in overdraft utilisation in agriculture. Elsewhere overdraft utilisation has shifted little over in the first half this year, leaving a good degree of headroom within existing facilities should it be required.

SME deposits

SMEs, in aggregate, emerged from the pandemic with a significant cushion of cash deposits. As the economy reopened and firms were hit with significant price increases across a range of inputs, that cushion has been eroded. **Chart 7** shows year-on-year falls in current account deposits since September 2022,



Source: UK Finance

picking up pace in the latter part of last year.

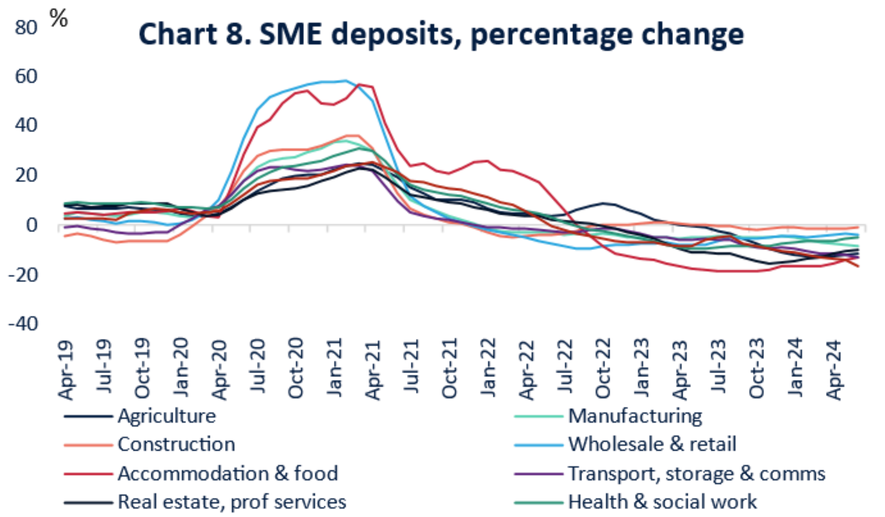
In the most recent quarter, the pace of decline in current accounts has started to slow, while that held in notice accounts has remained stable as some SMEs continue to take advantage of higher interest rates available.

The total value of deposits has levelled off over the quarter and at over £220 billion, SMEs retain a good deal of the deposit cushion accumulated during the pandemic. Total deposits are still some 14 per cent higher compared with the start of 2020.

The declining trend in cash deposits has been evident across all sectors of the economy (**chart 8**) – all businesses have been faced with similar cost pressures in recent years. Consumer-facing sectors, however, have been running down cash reserves at a more rapid pace than other parts of the economy – they have faced not only rising input costs, particularly food and energy, but additional pressure from rising wages, as these industries are somewhat more exposed to the recent large increases in the national minimum wage. Furthermore, those same cost pressures have affected customers and demand conditions in consumer-facing sectors have been especially challenging.

Clearly, deposit holdings are not equally distributed across firms, as evidenced by the recent rise in insolvencies in some of these sectors. Not all businesses have had the headroom available to weather recent economic challenges. Moreover, in the transport, storage and communications sector, total deposits at the end of the quarter had fallen back to the

levels reported before the pandemic. This is the only sector to have fully depleted the savings buffer accumulated during the pandemic, though real estate and professional services is not far behind.

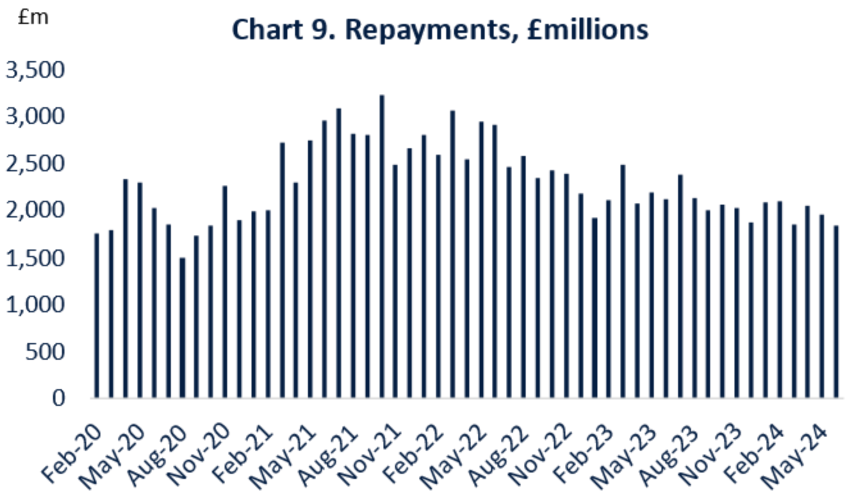


Source: UK Finance

This is in line with the latest ONS Business Insights and Conditions Survey (BICS), which shows that 38 per cent of businesses in transport and storage, and 29 per cent of real estate businesses reported having no cash deposits.

Finance Repayments

Turning finally to repayments, this metric has also been broadly stable over the past year, with repayments running to around £6 billion per quarter (**chart 9**). As noted earlier, with many SMEs with outstanding Covid loans still having a few years of repayment remaining, repayments of this magnitude look set to continue. Our data shows that outstanding loans on fixed rates (likely to include a large portion of Covid loans) have fallen by 42 per cent since the peak in 2021.



Source: UK Finance

Again, the ONS BICS survey gives us some insight into how businesses feel about managing their debt obligations. The latest data (to June 2024) shows that over 80 per cent of those with any debt obligations are very or moderately confident about being able to manage. This has gradually increased over the course of this year, though early conversations with lenders are always encouraged for those that are concerned about loan repayments or any other aspect of business finance.

SME finance outlook

Lending to SMEs appears to be gradually turning a corner after a somewhat prolonged slump in demand for new finance. With new approvals also continuing to rise in the most recent quarter, lending growth should continue in the near term. While these are positive developments, it is also clear that the pandemic continues to cast a long shadow and finance trends remain some distance from pre-Covid norms.

While gross lending is picking up, it is likely to be outpaced by repayments, particularly if SMEs maintain their ambition to pay down debt or remain debt-free. There are, as yet, only tentative signs in survey data (e.g. the SME Finance Monitor and Credit Conditions survey) of an increased need or appetite for new finance. And for SMEs that do have an appetite to borrow to support growth, they may need to see a more sustained improvement in the demand environment before committing to plans for expansion or business development. Lower interest rates could also make some investment opportunities a more attractive prospect, though noting we will not be returning to the ultra-low interest rates of the previous decade.

In the near term, SMEs continue to have something of a buffer in terms of cash deposits and headroom within existing facilities to navigate, what is expected to be, a gradual improvement in the economic environment through the rest of this year and into next. However, this cushion has been depleted with some sector now less well placed to manage through any new shocks, should they emerge.

While there has been a rise in business failures, overall SMEs have, once again, demonstrated resilience. But soon attention will need to return to longer-term issues such as progress on net zero, improving productivity and harnessing new technologies. And the finance sector will also need to demonstrate its support for SMEs as they take on these priorities.

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