UK FINANCE

Business Finance Review

UK Finance provides a regular analysis of how SME finance needs are being supported through lending from mainstream lenders and specialised finance providers, and also further information about the provision of deposit accounts. This latest *Business Finance Review* provides a round-up of lending activity in Q1 2020. This will provide an important baseline we can use to understand how SME demand for finance and use of deposits will develop through the current period of unprecedented challenge and uncertainty resulting from the COVID-19 pandemic.

Stephen Pegge, Managing Director of Commercial Finance, comments:

"After being buffeted by uncertainty through 2019, SMEs were faced with the economic shock of the Covid-19 pandemic in the early months of 2020.

"While the full effects of lockdown were not felt until the end of March and support measures were not fully operational until April, our data shows that many companies entered this period with some degree of financial headroom through a combination of existing facilities and deposits.

"Nevertheless, there were some early actions to get the right financing in place to manage through the oncoming downturn. This was initially focused on new overdraft facilities, where we see some notable growth across all industry sectors and regions.

"The finance industry has also been working closely with government, regulators and businesses as additional support schemes have been introduced to manage through this crisis and will continue to assist viable businesses as they plan for recovery."

2020 Q1 HIGHLIGHTS

- **Gross lending totalled £5.6bn in Q1 2020, marking the second consecutive quarter of decline.**
- **SME deposits edged higher over the quarter.**
- **Businesses had a degree of financial flexibility ahead of the Covid-19 lockdown with access to unutilised overdrafts and IFABL products.**
- **However, the number of loans and overdrafts approved in the first three months of the year rose.**
- **Lending approvals were concentrated in new overdrafts, which picked up in February and accelerated in March.**
- **Growth in approved overdrafts was widespread across sectors and regions, but particularly marked in hard-hit service industries.**

Economic context

Business finance activity over the first three months of 2020 was driven by two sharply contrasting trends. At the beginning of the quarter there was a bounce in confidence as political, and particularly Brexit-related uncertainty, started to ease. However, any recovery in investment plans was quickly derailed by the spread of the coronavirus pandemic.

We saw the first signs of business concerns about the impact of Covid-19 emerge in March with the UK's flash composite PMI (an indicator of business activity across the economy) recording its fastest downturn in the survey's history. This rapidly deteriorating picture was mirrored across Europe.

Official data confirmed the early hit to growth, with ONS confirming a 5.9 per cent fall in GDP in March alone, leading to an overall contraction in the economy of 2.2 per cent in Q1 2020. Output declines were widespread across sectors. Manufacturing, which had been struggling through much of 2019, shrank by nearly ten per cent in March and construction, which was also hit by the effects of poor weather in February saw a further seven per cent fall in output in March. But it was consumer facing service sectors, such as hotels and food service industries that saw the biggest hit to output as Covid-19 lockdown restrictions came into force at the end of the quarter.

A suite of support measures for businesses were quickly implemented in response to the crisis. These were designed to support companies' cashflow and to minimise the labour market impact of the economic shutdown. While this Review does not cover the roll out of these measures, insights are available on the pace of uptake through April and May, with more granular detail becoming available for the Q2 Review.

Forecasts for the trajectory of the economy continue to be plagued by uncertainty. Further deterioration in activity has been recorded through the second quarter, but the outlook for the second half of this year, as lockdown restrictions continue to be eased, are looking somewhat brighter, with early indications that business confidence indicators are nudging back into positive territory.

Sustaining this outlook will depend on continuing measures to protect public health; consumer and business confidence to spend and invest (both in the UK and in our major markets); and the extent to which this confidence is further boosted in any upcoming fiscal announcements from the government to support the recovery.

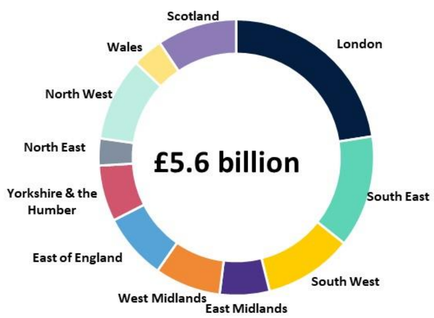
We are, however, also seeing some evidence that Brexit uncertainty is re-emerging. The deadline to secure a new trading agreement with European Union partners is fast approaching, and the current lack of clarity on detail could present a further barrier to a recovery in business growth plans and investment.

The current forecasts for growth from NIESR point to a 20 to 25 per cent contraction in the second quarter of 2020, but that this will be the trough of the recession, with a partial recovery in GDP growth getting underway in second half of this year.

SME Finance

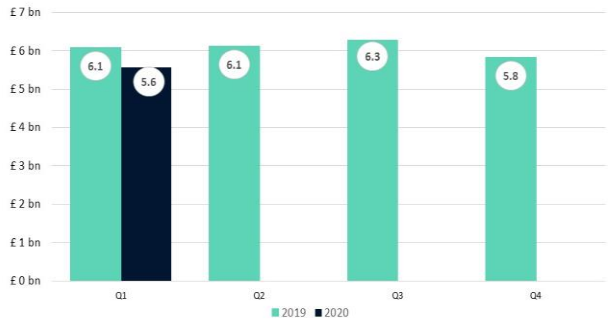
After a fairly flat picture on business lending activity in 2019, the first three months of this year saw gross lending to SMEs trend down for the second quarter running. At £5.6 billion, total new lending on loans and overdrafts ***(chart 1)*** was 4.3 per cent lower than in the final quarter of 2019 ***(chart 2)***.

Chart 1: Gross lending to SMEs as at Q1 2020



Source: UK Finance

Chart 2: Gross lending to SMEs in 2020 compared to 2019



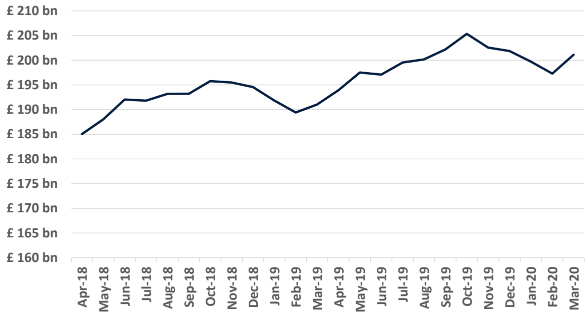
Source: UK Finance

This decline in new lending is a function of the drop in applications we reported in the previous Business Finance Review. As we noted last time, applications have been declining since 2016, and this accelerated across all sectors at the end of last year, in response to the political and economic uncertainty discussed in the earlier section. The effect of this uncertainty was further confirmed by the contraction in business investment reported by ONS at the end of last year.

This outcome is therefore evident in the further moderation in new lending recorded in the early months of 2020.

As businesses have held off investing and had limited need for new additional finance in recent quarters, so we saw a corresponding pick up in deposits at the end of the quarter ***(chart 3)***.

Chart 3: Total SME Deposits



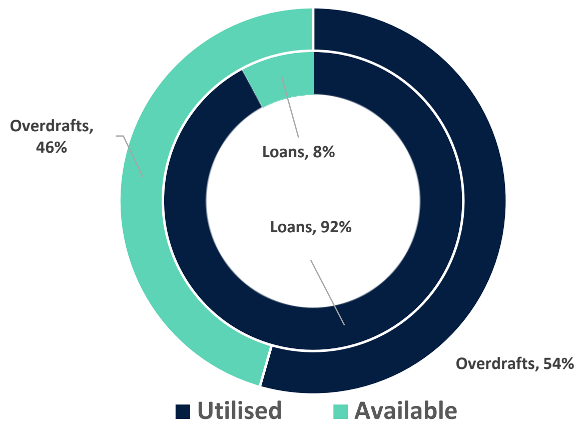
Source: UK Finance

Heading into the Covid-19 crisis, this was one aspect of the financial flexibility that companies had available to them to manage the impact of new restrictions on their operations. Additional headroom was also available to SMEs within existing financial arrangements, such as unutilised overdraft facilities, invoice finance and asset based lending (IFABL).

Looking firstly at overdraft usage ***(chart 4)***, just over half of overdrafts were being utilised (54 per cent) in Q1 2020. This was unchanged from the picture at the end of 2019 and slightly lower than the same time a year ago (60 per cent in Q1 2019).

As we noted last time, there is some sector variation in utilisation rates and industries such as construction, manufacturing and human health services continued to have a greater degree of flexibility within current arrangements, due to lower usage rates than the economy average, at the start of this year. At the other end of the utilisation spectrum we see sectors such as agriculture, accommodation & food service and recreation.

Chart 4: Utilisation and borrowing headroom

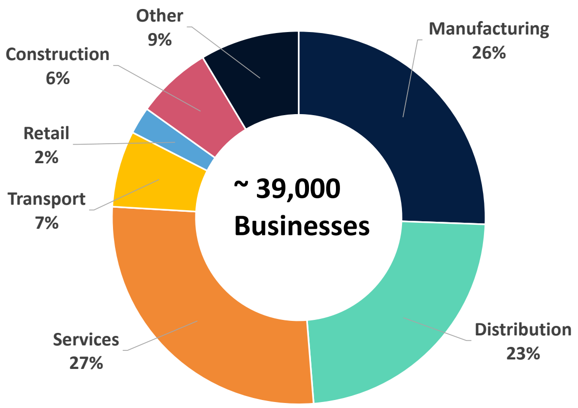


Source: UK Finance

Turning to invoice finance and asset based lending, just under 39,000 businesses were accessing these alternative forms of finance in the first quarter of this year. This number has been trending slightly down over the past year and at the end of March the number of IFABL clients was down 3.5 per cent on a year ago.

The mix of products used, has however, been relatively stable with around three-quarters of clients using domestic invoice finance and domestic factoring. Similarly, the client base across industry segments has been fairly static with around half of business done with manufacturing and distribution clients – sectors in which there is a high degree of business to business trade.

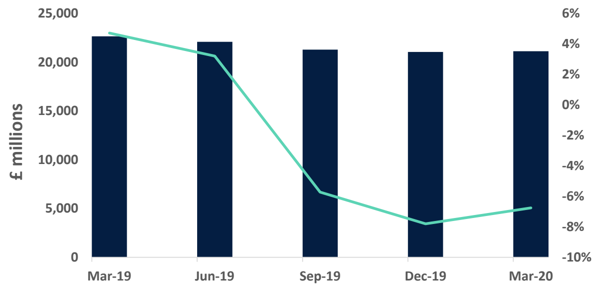
Chart 5: Client distribution



Source: UK Finance

These finance options provide cash advances against client sales, which offer another ready support to cashflow. At the end of the Q1 2020, client sales stood at just shy of £67 billion against which advances of £21 billion were made, around £9 billion of which was advanced to SMEs (with a turnover of less than £25 million).

Chart 6: Advances at quarter end



Source: UK Finance

These volumes have dropped across recent quarters, albeit from a record high in Q4 2018, and in Q1 2020 total IFABL advances were 6.8 per cent lower than the same period a year ago. With sales volumes taking a hit, as a consequence of the Covid-19 pandemic, we can expect a continuation of this trend in the coming quarter.

Taken together – unused overdraft facilities, existing IFABL arrangements and deposits on account, many businesses would have had something of a financial cushion heading into the economic downturn. The ONS *Business Impact of Coronavirus Survey (BICS)* noted in its first wave in mid-March that around 40 per cent of businesses were confident they would have sufficient financial resources to weather the crisis.

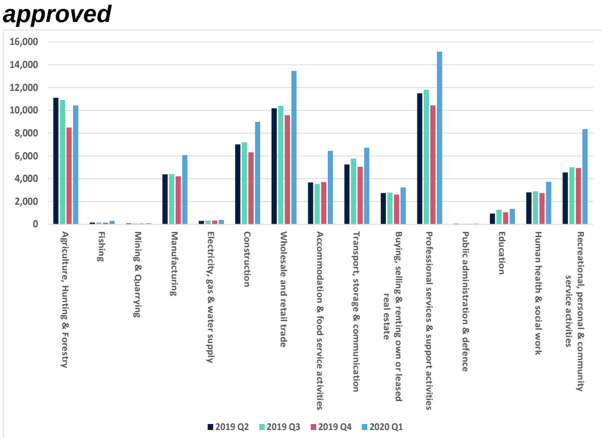
The sector breakdown of this confidence tallies with where we see greater headroom in facilities in our data. For example, firms in manufacturing were most optimistic about their financial position at the outset of the crisis compared with more consumer facing service sectors, such as recreation and leisure.

Additionally, research from UK Finance and BVA-BDRC, showed that one of the most common responses by businesses to the onset of the crisis was to make more use of existing finance arrangements (23 per cent of businesses) rather than increasing or extending lines of credit to the business.

While many businesses had some headroom within existing arrangements, the number of new loan and overdraft approvals over the quarter has seen a notable increase compared with levels reported through much of last year.

As ***chart 7*** illustrates, the rise in loan and overdraft approvals in the first three months of this year, which was widespread across major industry segments. In total the number of loans and overdraft approvals was 41.9 per cent higher in Q1 2020 compared with the previous quarter. While there was growth across all sectors, the increase was especially marked in accommodation & food service (up 74 per cent) and recreation and personal services (up 69 per cent).

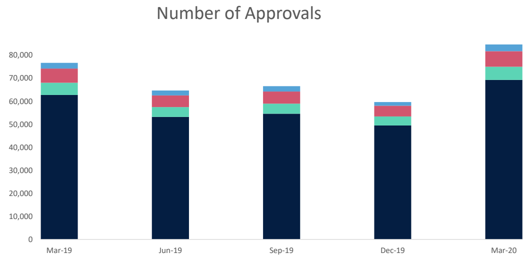
Chart 7: Number of SME loans and overdrafts approved



Source: UK Finance

Similarly, there was a pick-up in facilities approved across regions ***(chart 8).*** This consistent growth in applications speaks to an early business response to the Covid-19 crisis. However, the data in this Review largely pre-dates the introduction of government support schemes for businesses, most of which were not fully operational until April.

Chart 8: Numbers of loans and overdrafts approved across the UK regions

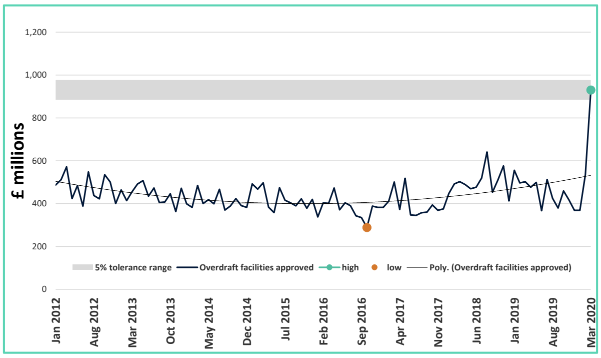


	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Northern Ireland	2,482	2,121	2,303	1,626	2,933
Scotland	6,152	5,052	5,269	4,657	6,721
Wales	5,318	4,291	4,374	3,899	5,753
England	62,780	53,234	54,631	49,525	69,302

Source: UK Finance

Further analysis shows that the growth in facilities approved is very much an overdraft, rather than a loan, story. ***Chart 9*** shows that the marked bounce in the value of overdrafts agreed, which began in February and accelerated in March. This would be a rational approach by businesses looking ahead to potential economic downturn to increase their safety net with a new or increased overdraft, which is likely to be a more straightforward undertaking than taking forward a loan application.

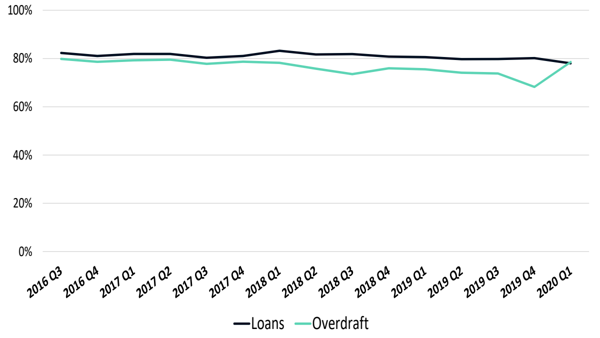
Chart 9: Value of overdraft facilities approved



Source: UK Finance

Moreover, our data shows that approval rates across new applications over the quarter have held steady, with a consistent eight in ten overdrafts agreed in the first three months of this year.

Chart 10: Borrowing approval rates



Source: UK Finance

Clearly, the picture on new lending and applications will shift significantly in the next quarter. A major plank of the government's Covid-19 support package was an evolving suite of guaranteed lending for businesses, delivered mainly through a growing portfolio of accredited lenders.

Following government announcements on the introduction of the schemes, the ONS BICS (wave 2) indicated that around a fifth of surveyed businesses were interested in accessing the accredited finance schemes to support their company through the crisis, with SMEs slightly more likely to be considering using them.

Importantly, the ONS survey waves also point to an increase in confidence amongst firms in their ability to manage their finances through the pandemic lockdown following the announcement of the government support package.

Data released by HM Treasury provides some early uptake of the government-backed lending schemes. By the end of June over 52,000 Coronavirus Business Interruption Loans has been approved and more than £29 billion of new lending has been agreed through the Business Bounce Back Loan Scheme. We know that businesses have continued to engage with the support measures through the second quarter and the programme has expanded as new lenders have become accredited. Our Q2 2020 Review will shed more light on the shape of uptake across sectors, regions and firm size.