SME lending in the cost of living crisis:

uncovering opportunity despite downturn

Introduction

Uncovering opportunity despite downturn

The year ahead is likely to be testing for UK SMEs – and for those who lend to them.

The UK economy is headed towards recession.

For lenders, this inevitably means increased risk across the entire market, but stress will particularly magnify in certain sectors.

But there are also significant opportunities. SMEs with the right profile that are, undoubtedly, excellent prospects for those that can find them.

Lenders will cut themselves off from those opportunities if they withdraw new lines of credit or limit their products.

To seize the opportunity, lenders need a fuller view of the risk posed by a business, and that means a more nuanced picture than the one provided by traditional credit scores alone.

There are still genuine opportunities to lend profitably and successfully to UK SMEs. Afterall, they have shown remarkable resilience in the face of four years of headwinds.

During this time SMEs have had to weather several significant challenges:

- Brexit and the burden of increased paperwork and bureaucracy
- COVID-19 and the associated lockdowns
- Sharp increases in fuel and energy costs
- Supply chain and employment challenges
- The shift to online channels for purchase and engagement

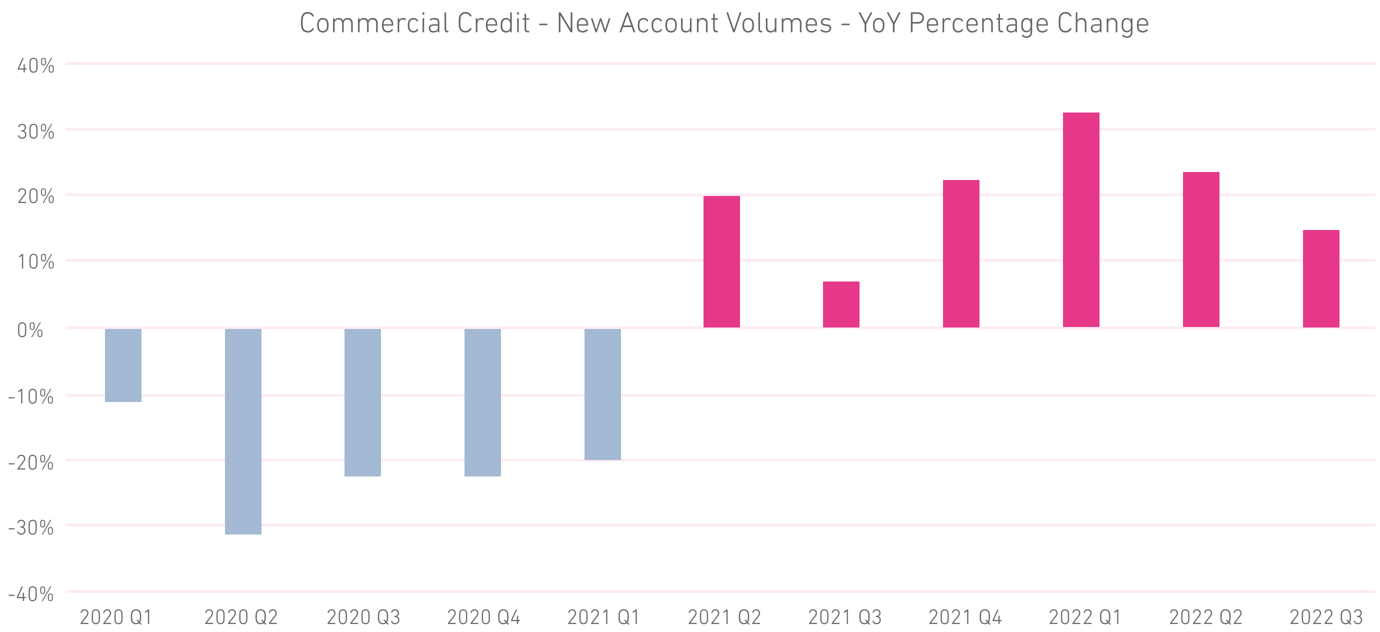
It is, therefore, remarkable that delinquency rates on SME credit are only a fraction above pre-pandemic levels.

The next challenge is likely to be a reduction in discretionary consumer spending as the cost of living rises.

In this changeable environment, lenders need the right tools to seize the lending opportunities that undoubtedly still exist.

This paper shows what the state of the SME lending market is today, and introduces the tools that will help lenders thrive during the downturn.

SME lending today
The post-pandemic bounce



6 Consecutive quarters in which lending volumes have grown year-on-year.

Following the pandemic years of 2020 and 2021, the SME credit market is recovering.

COVID-19 brought a drop off in lending to SMEs, if not the cliff edge some predicted. (Note: these figures do not include borrowing under the COVID-19 support CBILS and BBLS programmes.)

Volumes of lending in the lockdown year of 2020 were

↓ **20%**

down on the previous 12 months.

But in 2021, we saw a rebound. And credit volumes for 2022 are better still; on track to be **14% higher than in 2021.**

How do volumes today compare to those pre-COVID-19?

Both the volume and value of lending to SMEs remain 6.5% below pre-pandemic levels.

This is mainly down to a smaller volume of business in unsecured and secured loans. Here, the total value of borrowing remains **34% below pre-pandemic levels** (all figures as of September 2022).

However, the value of lending via many other credit products is **significantly above 2019 levels:**

Asset Finance

21%

Revolving credit

17%

(v 2019 monthly average)

As the pandemic hit, many predicted a meltdown in the SME credit market. This has not happened.

Arrears, delinquency and default rates **SMEs still performing robustly on credit commitments**

With SMEs buffeted by successive shocks, we might expect to see them in pain on their credit commitments.

In fact, the picture is more positive.

Arrears rate (1+ missed payments): A varied picture across sectors

Although arrears rates have worsened in 12 of the 15 biggest industry sectors we looked at over the past 12 months, we have not seen a crisis. Nor is there a uniform picture across sectors.

Only three sectors have seen arrears rates rise by more than 20% in the past 12 months:

- **Retail**
- **Other Manufacturing**
  (a sub-sector of manufacturing producing consumer goods and other specialist items)
- **Construction**

Other sectors have shown remarkable resilience. Rates of companies falling into arrears have actually fallen in:

- **Agriculture, Forestry and Fishing**
- **Land Transport, Storage and Post**
- **Administrative and Support Services**

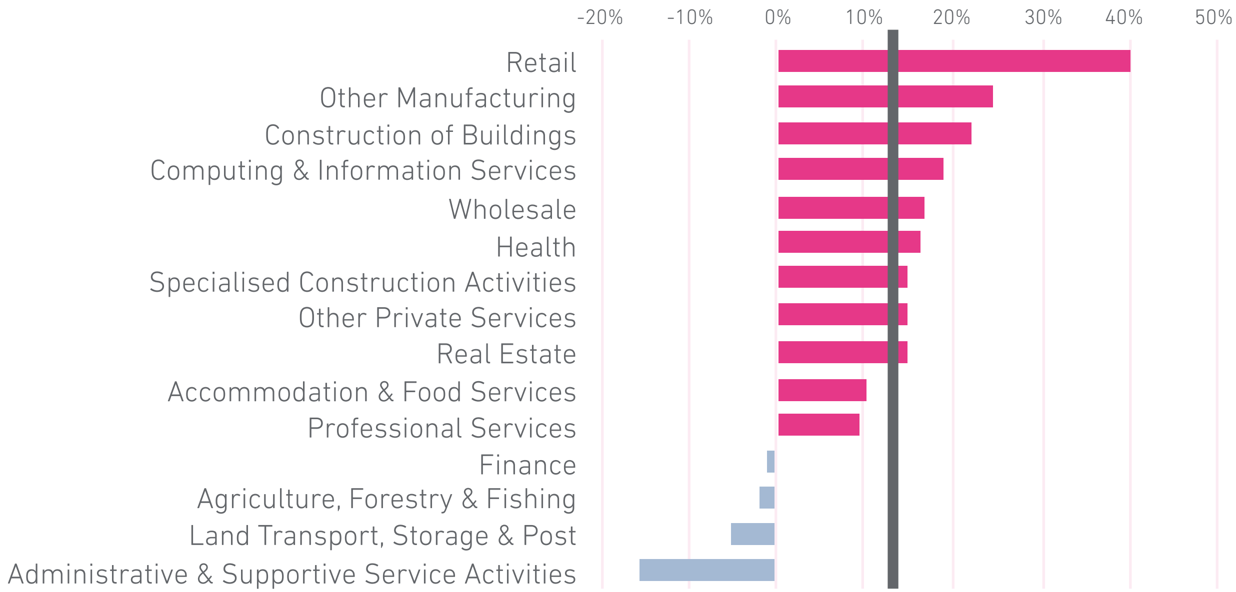
SMEs involved in transport and logistics activities are an interesting example. Hit hard by Brexit, driver shortages and soaring fuel prices in 2021, the arrears rate recovery in this area of the economy demonstrates the ability of some sectors to bounce back very quickly as they adapt to adverse conditions.

Delinquency rate (2+ missed payments): Remarkable SME resilience

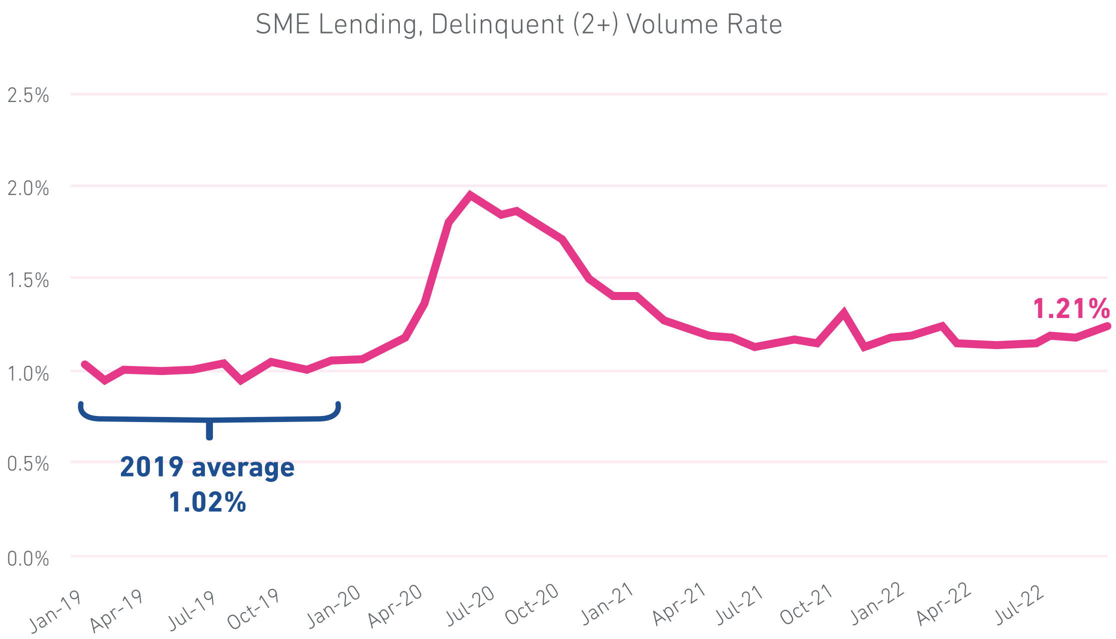
A better indicator of genuine business distress is delinquency (two or more payments missed over 12 months).

And here SMEs have shown great consistency in meeting credit commitments.

% change in Arrears Rate over Last 12 Months (Top 15 Sectors on Bureau)



Retail arrears have increased sharply over the last 6 months



The delinquency rate is higher today than pre-pandemic. But only very slightly – **1.21% in September 2022 versus 1.02% across 2019.**

After the COVID-19 shock of 2020 Q1&2, the rate has settled. It is only slowly inching upwards, despite the strong headwinds of 2022.

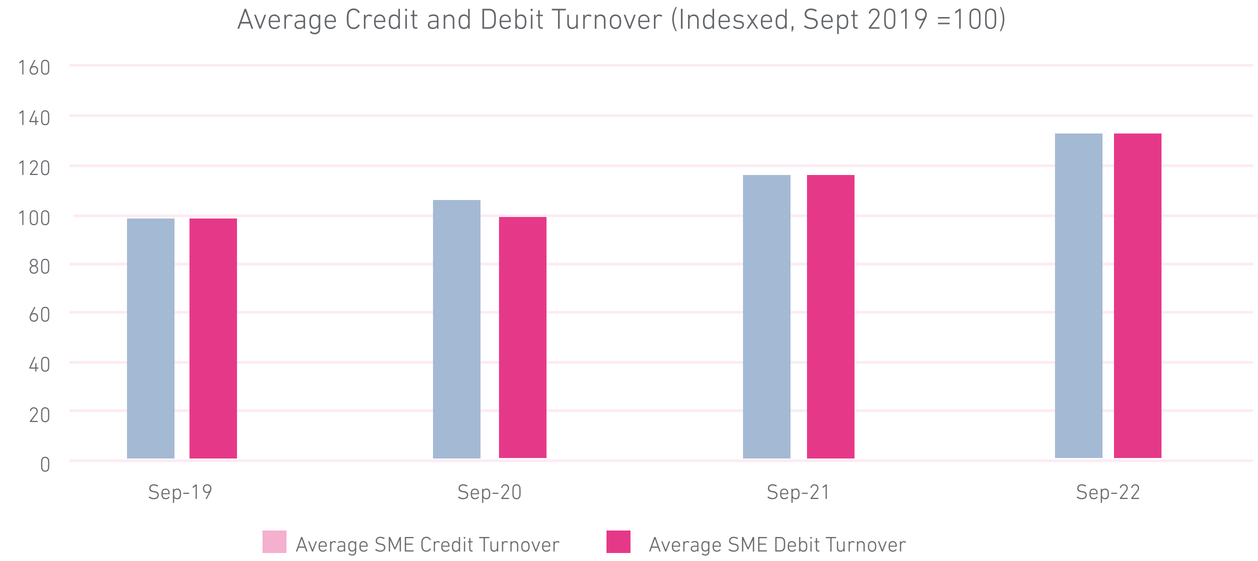
This suggests real robustness in the market.

The delinquency rate on business lending is **above 2019 levels** on most products - but has been **stable throughout 2022**

Why haven't we seen more **SME credit delinquency?**

With costs spiking and inflation at a 40-year high, why have SMEs proved so resilient?

In short, because they have been able to pass on cost increases rather than absorbing them.



Part of the reason for this resilience - there is evidence that companies have been able to pass on, **rather than absorb, increasing costs**

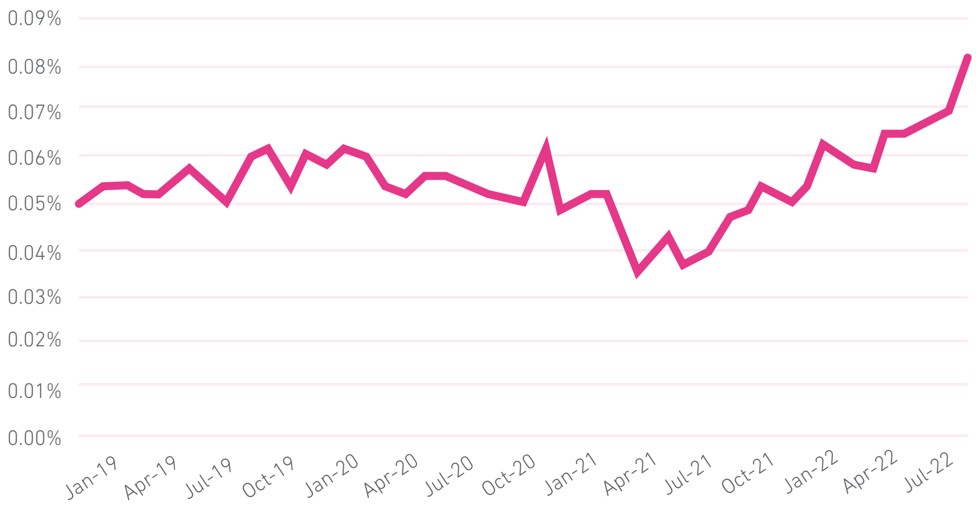
Account turnover data suggest SME costs are up more than **30% on September 2019 levels.** But so is income. And although people are buying less, they are doing so at higher prices, so delinquency has remained low.

Whether they can continue passing on these costs is a crucial question that is likely to further influence who will survive the next 12 to 18 months, after which inflation is expected to fall.

Default rates (businesses in breach of credit contract): Some pressures beginning to show

The number of accounts in default is growing, but not uncontrollably.

Monthly Default Rate



It has been trending upwards since April 2021. **As of September 2022, a touch over 0.08% of SME credit agreements were defaulting each month. This compares with a pre-pandemic 0.05-0.06%.**

However, even allowing for this rise, only a tiny fraction of companies are in default – fewer than one in a thousand.

And, again, not every sector is suffering equally.

With consumers cutting back on spending, it is the SME sectors most heavily exposed to consumer demand which are feeling the most pain:

- Accommodation and Food Services **default rate 3 x that of a year ago** (September 2021)
- Retail **more than 2.5 x**
- Construction **more than 2.5 x**

A complex picture of risk and opportunity

What we see is a complex picture. It is a concern that in some sectors more businesses are struggling to meet repayments than in past years.

But some sectors present significantly more risk than others. And there are still excellent, strong businesses that will provide value to smart lenders with the tools to identify them, even in sectors that may otherwise be showing signs of stress.

Smart lending during a downturn

History suggests that lenders who continue to invest during downturns grow more strongly afterwards.

But that leaves questions unanswered.

Which are the SMEs to back?

How can lenders find the opportunities without over-exposing themselves to risk?

Other sectors have shown remarkable resilience. Rates of companies falling into arrears have actually fallen in:

Agriculture, Forestry and Fishing
Land Transport, Storage and Post
Administrative and Support Services.

The tools for the job

Traditional credit-risk scores – like Experian's Commercial Delphi – are part of the toolkit to answer those questions. But this is using historical behaviour to predict future risk.

In a lending landscape with more potential risk, more sophistication in the analysis is needed to identify hidden opportunities and future growth prospects.

That is why Experian offers four tools to identify opportunities in a recession.

Tools to identify opportunities in a recession

Credit risk scores | **Survivability** | **Growth score** | **Affordability**

Together, they give a 4D picture – one that reveals new pockets of opportunity, as the rest of this report explores.

Seeing the whole picture

A 4D perspective on SME risk and opportunity

We can provide lenders with four key categories of data. Each of these data points captures something different about the health of a business.

#1 Credit Risk

#2 Survivability

#3 Growth

#4 Affordability

#1

Credit Risk

An established measure – Commercial Delphi

helps identify those businesses more likely to fail over the next 12 months based on a complex blend of current and historic data assets

Based on analysis of their commercial credit score, almost a quarter of UK SMEs remain Low or Very Low risk. This means that there is a proportion of SME's that have a healthy credit profile and may have the capacity to afford credit now.

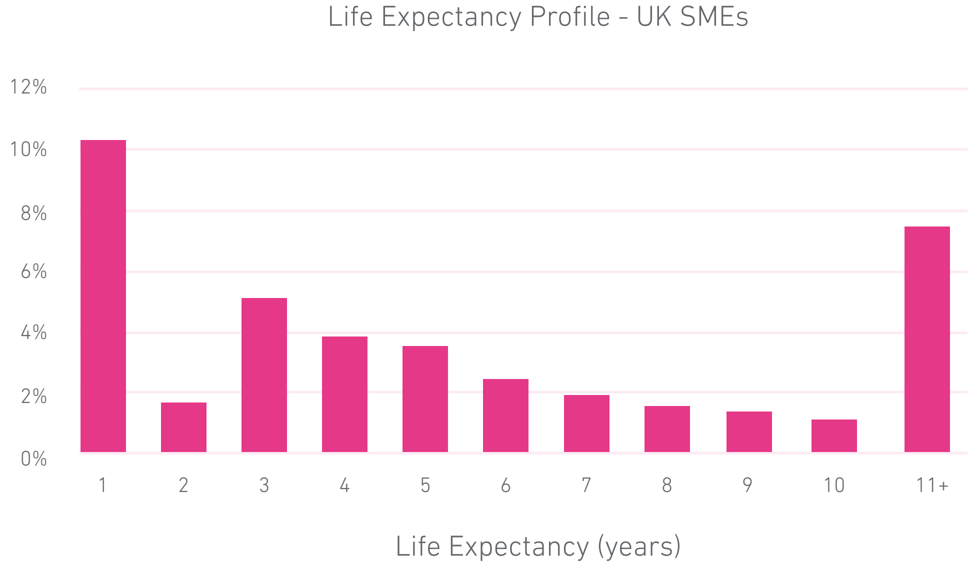
Another quarter (24%) fall into the high or maximum risk bands.

60% of businesses in the High or Maximum risk bands are young companies (formed in the last five years).

#2 Survivability

Measure of the life expectancy of the business.

Experian's SME Survivability score shows that **11% of UK SMEs will likely fail in the next year, increasing to 16% over the next three years.**



8% are likely to last 11 years or more.

The sectors with the highest numbers of businesses likely to fail within a year are:

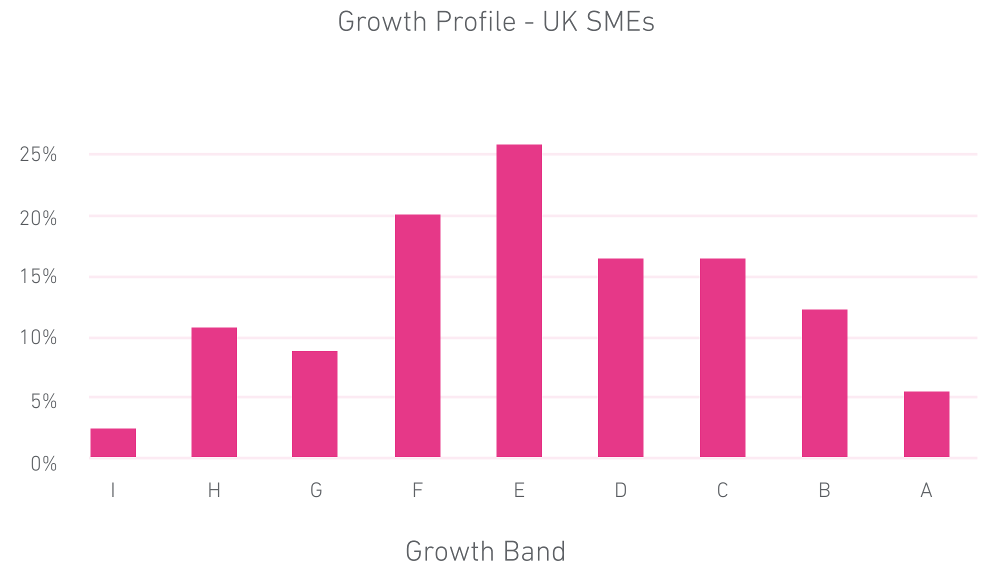
- Professional Services
- Retail
- Food Services

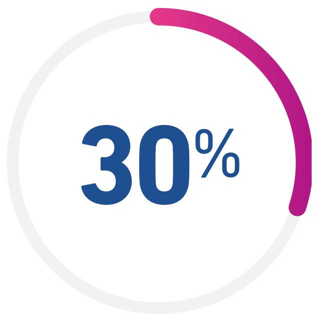
#3 Growth

Measure of growth potential

30% of UK SMEs fall into the highest growth bands (A-C). The typical company in these bands is more established (5+ years old).

Stronger sectors for growth include Construction, Wholesale and Retail.





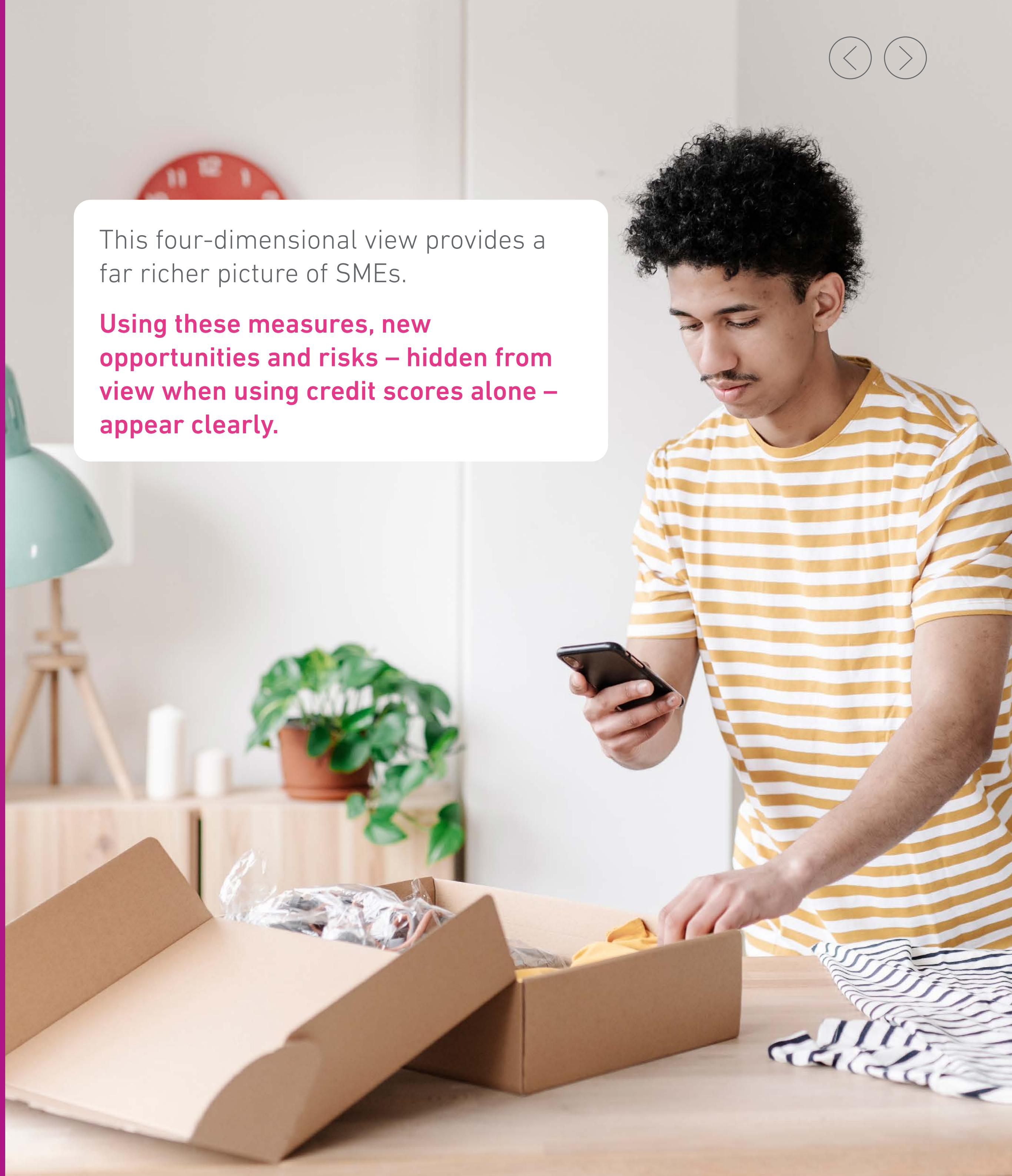
of UK SMEs fall into the highest growth bands (A-C).

#4

Affordability

Measure of a business's ability to afford further lending.

With it not being mandatory for all small limited companies to file profit and loss figures, the use of core bureau data to assess their capacity to take on further debt is paramount in determining whether to approve additional financing.



This four-dimensional view provides a far richer picture of SMEs.

Using these measures, new opportunities and risks – hidden from view when using credit scores alone – appear clearly.

Finding hidden pockets of lending opportunity **in the SME sector**

There are pockets of hidden risk and significant opportunities within the SME community.

These pockets become apparent when we layer the four measures mentioned in the last section on top of each other. When we do that, we see the sector with new eyes.

For instance, a creditworthiness check predicts a business's potential likelihood of failure within the next 12 months, based on the full range of data we have available.

But, sometimes, low risk businesses have relatively weak growth prospects, while more ambitious, growth-oriented SMEs look riskier because of how they are using credit to fuel expansion.

The SME picture is complex. It is essential to look at the whole businesses, rather than single measures in isolation.

We reveal previously hidden opportunities and dangers by using the four metrics together.

An example of the 4D approach at work

Take firms with low credit risk as an example. Some may present excellent opportunities:

21% of UK SMEs have low credit risk, long life expectancy and mid or high-growth prospects.

But others probably present more risk than a credit score alone reveals:

4% of SMEs with low credit risk also have low growth scores and low life expectancy. We can help you avoid that potential hidden pitfall.

This graphic explores the size and nature of some risk and opportunity pockets for SME lenders.

Sizing pockets of opportunity and risk

These tools reveal a picture with much more complexity – and potential opportunity – than might appear at first glance.
They are particularly valuable in a recessionary environment.

Working with you, we can map these risks and openings to:

- **Minimise your risk exposure, while avoiding costly over-caution**
- **Exploit hidden opportunities**
- **Refine lending strategies and criteria.**

To find out more about identifying opportunities for growth in SME lending, get in touch

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