Business Distress Index December 2012

Stagnating economy

The latest R3 Business Distress Index comes against a background of economic uncertainty. There have been positive signs that the UK was exiting recession with upbeat GDP figures showing the economy grew 1% June – September. Yet we have seen the gloomy outlook by the Chancellor in his Autumn Statement revealing that we will remain in a period of persistently low growth. R3's Business Distress Index sheds some light on the current uncertainty, showing that distress signs have plateaued and growth signs have slightly fallen, providing further evidence that the economy is stagnating.

Uncertainty? This is what is happening on the ground…

Business Distress

The level of business distress has remained stable; 54% of businesses are experiencing at least one sign of distress, compared to 53% in June. The number of businesses reporting distress signs has slightly fallen for a second consecutive quarter across two 'distress categories': **Experiencing Decreased Profits** has fallen marginally by 1% to 33%, which compares favourable to 36% at start of the year. The number experiencing a **Fall in Market Share** is down significantly to 17%, from 27% at the start of the year. Some distress signs are up this quarter; **Making Redundancies** has increased to 10% from 5% in June but down from 13% in March. Using the **Maximum Overdraft Facility** has increased from 16% to 20% this quarter, yet still down from 30% at the start of the year. There has been no change in the number of businesses who have seen a **Reduction in Sales Volume** at 31% in November and June, down from 37% in March.

Distress levels remain elevated and growth signs have fallen slightly across UK businesses.

SMEs are suffering more distress than larger businesses.

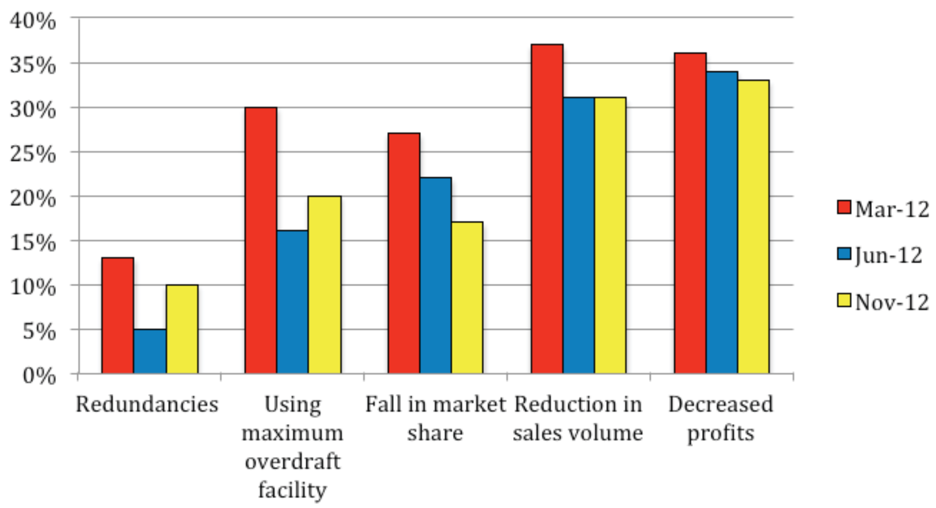
Construction (63%) and Hotel & Catering (64%) sectors have the highest levels of distress compared to a cross sector average of 54%.

33% of businesses are experiencing decreased profits, compared to 17% of businesses experiencing increased profits.

31% of businesses have a seen a reduction in sales volumes.

One in ten businesses have had to make redundancies.

Business Distress



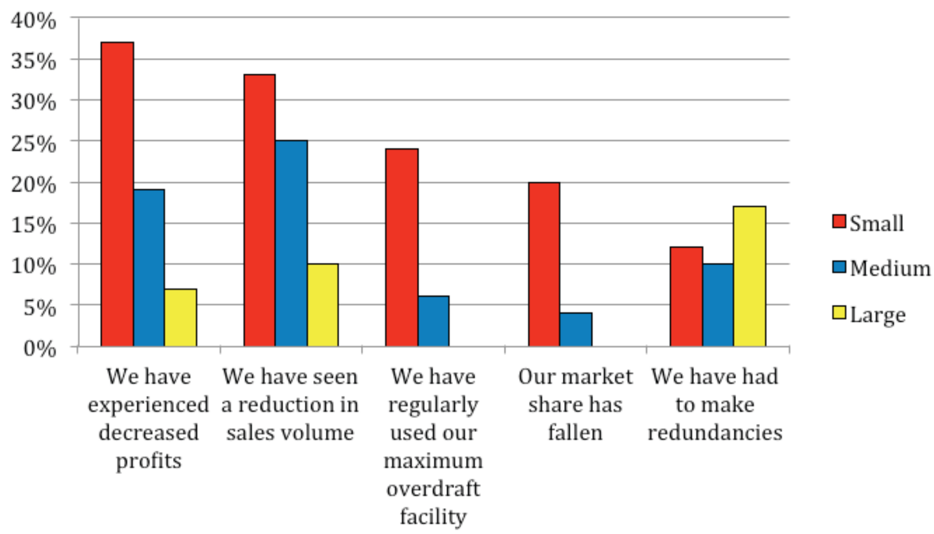
Lee Manning, R3 President, comments:

"During the two years R3's Business Distress Index has been running, distress signs have often fluctuated quarter on quarter. The fact that for the last three quarters distress signs have remained at a relatively similar level suggests the economy remains stagnant. A healthy economy requires activity at both ends of the economic cycle – it needs business growth and expansion, as well as recycling of capital following business failure. There has been no improvement to those businesses that are consistently reporting distressed signs. There are a significant number of businesses being kept alive by the forbearance of banks, other key creditors and favourable interest rates, which is enabling them to stay afloat but make no in-roads on their debt. However, they are in a precarious situation with little prospect of growth. Any change in circumstance, such as a loss of a major customer or increased creditor pressure could easily push them into insolvency."

"Whilst it's reassuring that a sizeable portion of businesses are relatively stable; with nearly half (46%) of businesses reporting no distress signs, the businesses that remain stuck in a distressed situation for a prolonged period are of most concern and their future is likely to have the biggest impact on the UK's economy. When the economy picks up many will be able to emerge as thriving businesses however inevitably some will eventually fail."

Small v Big business: Who is faring better?

SMEs are experiencing significantly high levels of distress compared to larger businesses. 37% of small businesses are experiencing decreased profits, compared to 19% of medium-sized businesses and just 7% of large businesses. In fact, across all distress signs, higher numbers of small businesses are suffering, with the exception of making redundancies.



Small: 2 – 50 employees; medium: 51 -250 employees; large: 251 + employees

Lee Manning comments:

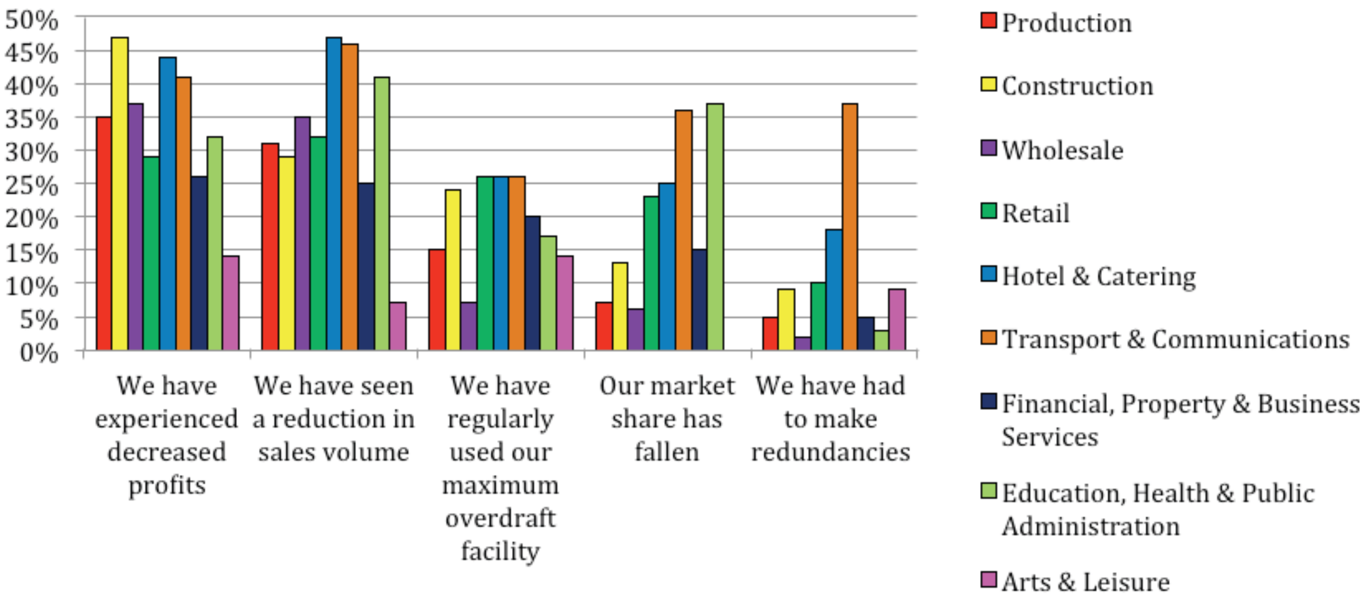
"Small businesses which are often owner-managed, offer a less appealing investment opportunity for third parties and consequently find it difficult to raise capital as investors and lenders find it easier to fund larger businesses. The monitoring required by external investors for a smaller loan to an SME is the same as a bigger investment in a large business and therefore the supervisory commitments required do not justify the economic rewards. An investor with substantial funds will prioritise larger ventures as it's easier to exit and capitalize on the investment at a later date."

"SMEs are also more vulnerable to any changes in the economic climate or a change in circumstance such a loss of a major customer or increased pressure from their creditors. SMEs are not able to diversify quickly enough to change their business in response to such events. Large businesses benefit from the financial resources to restructure which SMEs do not. Large businesses have the tools to relocate or cut head count for example. Put simply these SMEs do not have the money needed to restructure."

"For this reason, it is not surprising that the one area large businesses do have higher levels of distress is with regard to making redundancies – when trading conditions become difficult larger businesses have the ability to reduce head count to weather the storm. Unfortunately for small businesses, staff is often their most costly overhead but also the most fundamental. A small business has less flexibility to release staff and therefore has to balance a reduction in profits to maintain staff during difficult trading periods."

Business Distress: Sector analysis

The Construction and Hotel & Catering sectors are experiencing the highest levels of distress. 63% of construction firms are experiencing at least one sign of distress, whilst Hotel & Catering stands at 64%, compared to an average of 54%. 47% of construction businesses and 44% of Hotel & Catering businesses are experiencing decreased profits compared to the cross sector average of 33%.



Lee Manning comments:

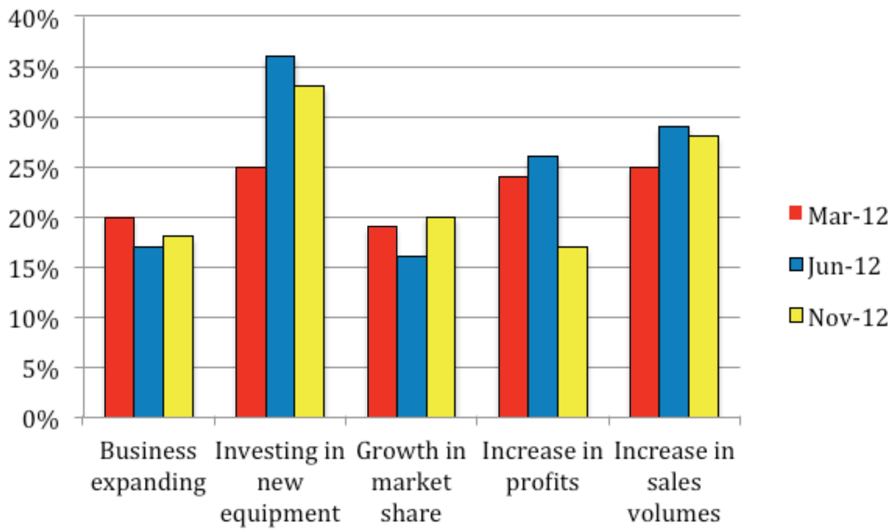
"Due to public sector contracts drying up it is understandable the construction sector is struggling. Other than in London, where building projects remain steady, the sector remains dormant and is experiencing extremely difficult trading conditions.

"In a stagnant, consumer driven economy it is unsurprising to see distress in the Hotel & Catering sector. Consumer confidence is currently low and discretionary spend continues to be compromised, due to rising fuel costs, increased alcohol duty and food prices being on the rise. Inevitably individuals have had to make sacrifices – eating out or having nights away are areas many have had no choice but to cut back on.

"To understand why the UK's hotel sector is struggling one only needs to look to mainland Europe where there is high unemployment and economic uncertainty; as a consequence significantly fewer European tourists can afford to come to the UK this year. In addition, during the Olympics many people stayed away from the capital for fear of overcrowding, which had a knock on effect to other UK tourist destinations."

Business Growth

On the whole, signs of business growth have decreased this quarter, with 51% of businesses experiencing some signs of growth compared to 57% in June. The most significant fall has been increased profits, with just 17% of businesses experiencing this growth sign. This compares to 27% of businesses in June experiencing increased profits. Business expansion has remained fairly constant throughout 2012, one in five businesses at the start of 2012 said they had expanded compared to 18% today. 33% of businesses have invested in new equipment, down from 36% in June but higher than 25% of businesses in March.



Lee Manning comments:

"Compared to the summer, signs of growth have slightly fallen which may be reflected in the next bout of GDP figures and will dampen the flickering flames of recovery. Unfortunately the Governor of the Bank of England's gloomy pronouncement may be proved correct; it seems the UK economy is unable to maintain any sustained level of growth. The biggest challenge is to find the impetus to initiate growth."

Methodology note: BDRC Continental conducted 501 telephone interviews with small, medium and large business owners and Financial Directors between 5th - 12th November 2012. Strict quotas are set by size, region and sector and the data weighted to be representative of the ONS profile of UK businesses, each with an annual turnover above £50,000. The respondent in each case is a senior financial decision maker. (Previous survey, 6th-13th June 2012)

About R3

R3, the insolvency trade body, represents over 97% of insolvency practitioners. R3's full members are all regulated by their recognised professional bodies, they can be licensed insolvency practitioners, solicitors, chartered accountants or certified accountants. They have extensive experience of helping businesses and individuals in financial distress.