Business Distress Index: Wave 14

Rising interest rates:
Putting growth to the test?

July 2014

Methodology

BDRC Continental conducted 500 telephone interviews with small, medium and large business owners and Financial Directors in June 2014. Strict quotas are set by size, and softer ones for region and sector. The data is weighted to be representative of all UK businesses with an annual turnover above £50,000. The weights applied are based on the business population data from the Department for Business Innovation and Skills (BIS). The respondent in each case is a senior financial decision maker.

Introduction by Giles Frampton, R3 President

"In our last edition of the Business Distress Index in February 2014, we saw a continuing trend of positive economic indicators in the UK business community and anticipated a positive economic outlook for UK plc for 2014. Six months into the year, we are pleased to see that our predictions are bearing out.

Wave 14 of the Business Distress Index gives us lots of good news – the levels of business distress are remaining at record low levels and signs of business growth are at record high levels. It comes as no surprise that increasing numbers of businesses are feeling confident about their own prospects and are even more optimistic about the economy than they were three months ago.

We also predicted that it would not take much to knock this trend off course: external economic shocks, for example, could have a significant impact on businesses. Therefore we decided in this wave to investigate how businesses felt about the prospect of an inevitable increase in interest rates. The findings have provided some shocking results.

A sizeable minority of businesses – 22% - say they would be put into financial difficulty if there was a one percent increase in interest rates. Out of this, 6% of businesses would be put into 'serious' financial difficulty. 7% of businesses say they would financially benefit.

How much of this concern is about perception is unknown, but when it comes to something as crucial as the prospect of having to pay back more on your borrowing, perception can often be everything in maintaining business confidence.

For some businesses a small interest rate rise will put them on the brink of insolvency. These results are consistent with previous R3 research into the number of 'zombie businesses' in the economy - businesses that can only pay off the interest on their debts (6% of UK businesses). These are businesses that are most likely to feel a negative impact from a rate rise.

Commentators have warned that to date, low interest rates have been masking the number of businesses who are truly in distress and potentially risk facing insolvency and destabilising the recovery. R3's research supports these warnings.

Nevertheless, there is a lot to celebrate from this latest survey, with its record breaking levels of business growth and low levels of business distress."

Giles Frampton, R3 President

Executive summary

1. Interest Rates

- One in five (22%) businesses would experience financial difficulty should there be an interest rate rise of one percentage point or more in the next 18 months – 6% of whom would be in 'serious' financial difficulty.
- This is compared to just 7% of businesses that say they would experience a financial benefit.
- The majority of businesses (70%) say they would be unaffected, experiencing neither positive nor negative effects.
- Businesses in the north of the country are most likely to say they would be negatively affected: 26% of businesses in the north, 21% of businesses in the midlands and 19% of businesses in the south say they would experience financial difficulty.
- An increase in interest rates is more likely to benefit sole traders rather than larger businesses (businesses with over 250 employees): 25% of larger businesses said they would experience at least some financial difficulty as opposed to 15% of sole traders, whilst 10% of sole traders said they would experience at least some financial benefit compared to 8% of large businesses.

2. Business Distress

- The number of businesses in the UK experiencing business distress remains near record lows.
- 35% of businesses in the UK are showing at least one sign of business distress, almost half the number from two years ago in March 2012 (64%).
- Larger businesses are still experiencing fewer signs of distress compared to sole traders: 10% of larger businesses are experiencing one or more signs of distress, compared to 31% of sole traders.
- The proportion of businesses experiencing decreased profits and reduced sales volumes are at record lows.
- The proportion of businesses regularly using their maximum overdraft has increased since the last survey; this could be a sign of businesses using credit to facilitate growth.

3. Growth

- The levels of UK business growth remain at record highs.
- 68% of businesses reported experiencing one or more indicators of growth: an increase of three percentage points from the last survey in February 2014 and a 22 percentage point increase from two years ago.
- Businesses are most likely to be experiencing an increase in sales volumes: the most common out of all five growth indicators (41%).
- Business growth is uneven around the country: 55% of businesses in the North East and Yorkshire and Humber are experiencing one indicator or more of growth, the lowest out of all regions, whilst 84% of businesses in Greater London are experiencing one indicator or more of growth, the highest proportion out of all regions.
- Larger businesses continue to show more positive signs of growth compared to sole traders: just under half of all sole traders are experiencing one or more indicators of growth (49%) compared to 82% of larger businesses.

4. Business Confidence and Economic Optimism

- Business confidence remains at record high levels.
- The proportion of businesses who expect their activity to decrease over the next 12 months is at a record low.
- Larger businesses (69%) are more likely to expect increased business activity than sole traders (42%) by a margin of 27 percentage points.
- There is a significant increase in the proportion of businesses that are optimistic about the economy compared to the last survey in February 2014.
- The proportion of businesses that are pessimistic about the economy has decreased by five percentage points since the last survey.
- Larger businesses (69%) are still more optimistic about the economy than sole traders (57%).
- Businesses in the South East are the most pessimistic about the economy.
- There is a significant increase in the proportion of businesses in the manufacturing industry that are more optimistic about the economy than three months ago; from 57% to 70%.

1. Increase in Interest Rates

Giles Frampton comments:

"Given the prospect of a small increase in interest rates on the horizon, it is encouraging to see that the majority of businesses say they would be unaffected by an interest rate rise of one percentage point or more over the next 18 months. However, despite this good news it is concerning that a sizeable minority - over one in five businesses – say they would be put into financial difficulty by such a rise.

It is also interesting to see that a higher proportion of sole traders say they would benefit financially than larger businesses – this may be because sole traders are more likely to be relying upon their own savings to fund their business and would welcome a greater return on their investments.

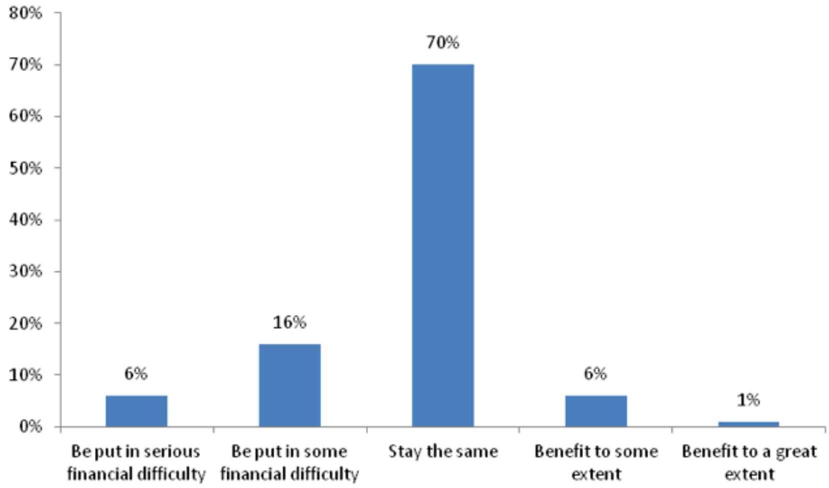
Due to the amount of speculation about interest rate rises over the last few months, we expect most businesses will have been planning ahead for the inevitable increase. This might explain why the majority of businesses say they would be unaffected.

Any interest rate rise will have the biggest impact on 'zombie businesses' – those that are only paying the interest on their debts – and personal finances. Research by R3 in November 2013 found that 6% of UK businesses (103,000 businesses) were only paying the interest on their debts, and not the debt itself.

We have not seen the number of insolvencies peak after the last recession as we would usually expect. This is primarily due to record low interest rates keeping businesses afloat and allowing extra time for businesses to get their finances in order.

We can expect a lot of businesses to be put to the test once interest rates go up."

- 6% of businesses say they would be put in serious financial difficulty should there be an interest rate rise of one percentage point or more in the next 18 months.
- 16% of businesses said they would be put in 'some' financial difficulty – making a total of over a fifth of businesses saying they would experience at least some financial difficulty (22%).
- This is in comparison to 1% of businesses that say they would benefit financially to a 'great' extent from an interest rate rise, and 6% that say they would benefit financially to 'some' extent – a total of 7% of businesses experiencing any financial benefit.
- The majority of businesses (70%) say they would be unaffected by an interest rate rise, experiencing neither positive nor negative effects.
- An increase in interest rates is more likely to benefit sole traders rather than larger businesses (businesses with over 250 employees); 25% of larger businesses said they would experience financial difficulty as opposed to 15% of sole traders.
- 10% of sole traders said they would experience financial benefit compared to 8% of larger businesses.
- 26% of businesses in the North, 21% of businesses in the Midlands and 19% of businesses in the South said they would experience financial difficulty.



- 10% of businesses in the North, 6% of businesses in the Midlands and 5% of businesses in the South said they would experience financial benefit.
- Almost a third of businesses in the retail and distribution sector (31%) would experience financial difficulty, compared to 28% of businesses in the manufacturing industry and just 13% in the services sector.
- 10% of businesses in the manufacturing sector say they would benefit financially, followed by the retail and distribution sector (7%) and services sector (5%).

2. Business Distress

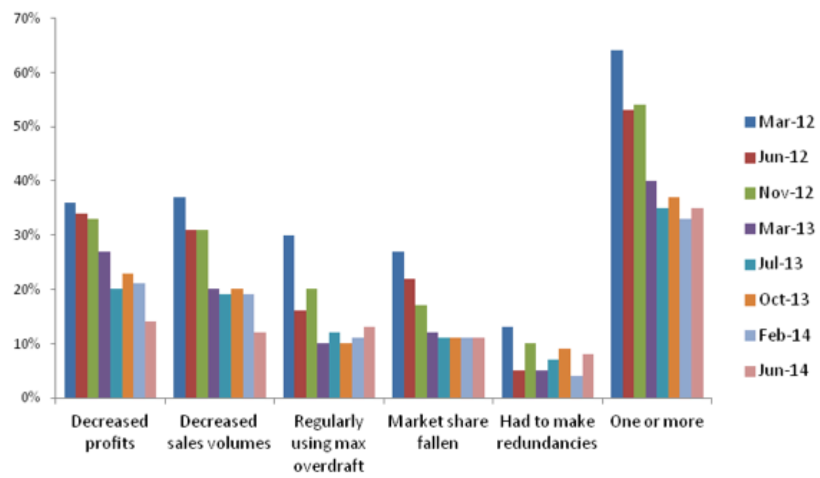
Giles Frampton comments:

“We are pleased to see levels of business distress remain at record lows. It is particularly encouraging to see a significant drop in the number of businesses experiencing decreased profits and sales volumes – possibly a sign that the economic recovery is picking up again due to increasing consumer demand.

One sign of distress that has increased however is the proportion of businesses regularly using their maximum overdraft. This could be a sign that businesses are using every available drop of credit to keep up with growth.

We will continue to keep a close eye on this and what happens to our distress indicators once interest rates start rising.”

- The number of businesses in the UK experiencing business distress remains near to record lows.
- 35% of all businesses in the UK are showing at least one sign of business distress, a small increase of two percentage points since February 2014 but almost half the number of businesses from two years ago in March 2012 (64%).



- 13% of businesses stated they had been regularly using their maximum overdraft, an increase of two percentage points since the last survey and a further percentage point increase from October 2013.
- 8% of large businesses have had to make redundancies, an increase of four percentage points from the last survey.
- The proportion of businesses recording a fall in market share remains steady at 11%, the same as the last three surveys and following a fall from 27% in the first survey.
- 14% of businesses reported experiencing decreased profits, compared to 21% in the last survey.
- Similarly, just 12% of businesses reported a reduction in sales volumes, a decrease of seven percentage points from February 2014.
- There is a significant difference between the numbers of larger businesses experiencing at least one sign of distress compared to sole traders: 10% of larger businesses (those with more than 250 employees) are experiencing one sign of distress or more, compared to 31% of sole traders.
- The Greater London region is showing the fewest signs of business distress with 70% of businesses experiencing no signs of business distress, and just 5% of businesses having made redundancies.

- 20% of businesses in the North have had to make redundancies, compared to 6% in the Midlands and 2% in the South.
- 69% of the retail and distribution sector is experiencing no signs of business distress, compared to 67% of the services sector and 56% of the manufacturing sector.

3. Growth

Giles Frampton comments:

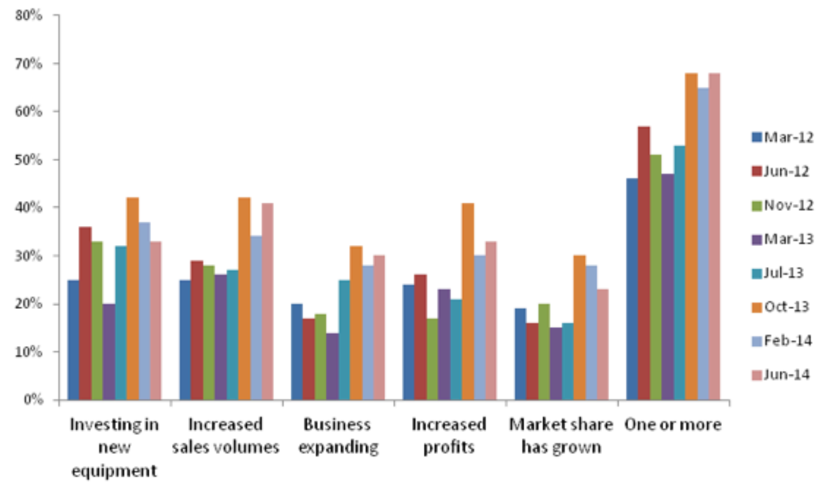
"R3's latest Business Distress Index shows UK businesses are still showing record signs of growth. It is reassuring to see consistently high levels of growth since October 2013 and demonstrating an upward trend for the last two years.

More businesses are experiencing an increase in sales volumes and profits, and perhaps most encouraging of all, more businesses are expanding (whether geographically, by size or into new markets). This is particularly welcome as it could mean more jobs being created across the country.

It is still unsurprising to see that businesses with the most signs of growth are concentrated in the Greater London region, and amongst larger businesses rather than sole traders. This could be due to a range of factors such as it being more difficult for sole traders and small businesses to access the finance that would enable them to expand and grow.

Similarly, a higher proportion of larger businesses are seeing increased profits as opposed to sole traders, as it is often easier for larger businesses to find cost-cutting measures that improve their bottom-line.

We will continue to keep track of this in the next few surveys and look closely at how widespread growth is being shared across the country and amongst businesses of all sizes."



- The proportion of businesses experiencing one or more indicators of growth has increased by 22 percentage points since 2012.
- 68% of businesses reported experiencing one or more indicators of growth: an increase of three percentage points from the last survey in February 2014, and a return to October 2013 levels (also 68%).
- The proportion of businesses experiencing an increase in sales volumes is the highest out of all five growth indicators (41%): an increase of seven percentage points from the last survey.
- 30% of businesses are expanding geographically, by staff numbers or in new areas of business (up two percentage points from February 2014) and 33% of businesses are experiencing increased profits (up three points from February 2014).
- 33% of businesses are investing in new equipment – a decrease of four percentage points since February 2014 (37%) and 23% of businesses are experiencing a growing market share - a decrease of five percentage points since February 2014 (28%).
- Just under half of all sole traders are experiencing at least one indicator of growth (49%), whilst 82% of larger businesses are experiencing one or more indicators of growth (businesses with over 250 employees).
- 59% of larger businesses are expanding whereas just 15% of sole traders are doing so and 38% of larger businesses are experiencing increased profits, compared to just 20% for sole traders.

- 55% of businesses in the North East and Yorkshire and Humber are experiencing one or more indicators of growth, the lowest out of all regions, whilst 84% of businesses in Greater London are experiencing one or more indicators of growth, the highest out of all regions.
- South West and Wales is the region with the least amount of businesses expanding (18%), whilst the region with the most businesses expanding is in Greater London (46%).
- The manufacturing industry and services industry have both experienced an increase in the proportion of businesses experiencing one or more indicators of growth: 68% of the manufacturing industry (an increase of ten percentage points from February 2014), and 68% of the services industry (an increase of four percentage points since February 2014). Whilst the proportion of businesses in the retail and distribution sector has decreased from 71% to 66% since February 2014.

4. Economic Optimism and Business Confidence

Giles Frampton comments:

"Given that signs of business distress remain at record lows and signs of business growth have been consistently high, we would expect to see businesses being confident about their own prospects and that of the economy as a whole. These latest results do not disappoint.

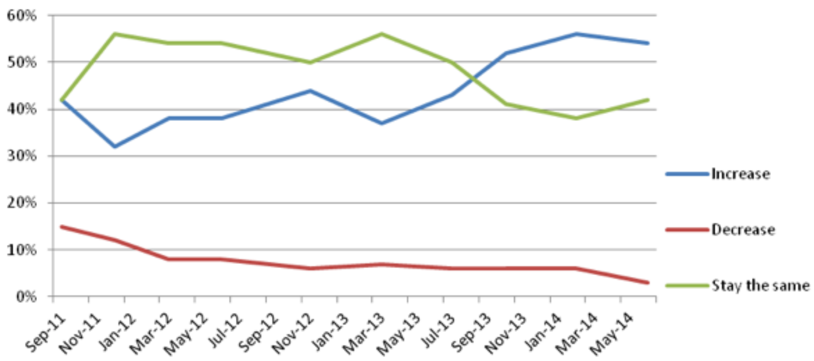
These figures also seem to translate to how businesses feel about the economy as well as their own prospects, with more businesses feeling positive about the future of UK plc than the last survey and significantly more than since this survey began four years ago – in the aftermath of the recession.

This renewed sense of confidence and optimism seems to be shared across the country and amongst all sectors.

Yet, there is still some way to go: larger businesses are still more confident and optimistic than sole traders."

Business Confidence

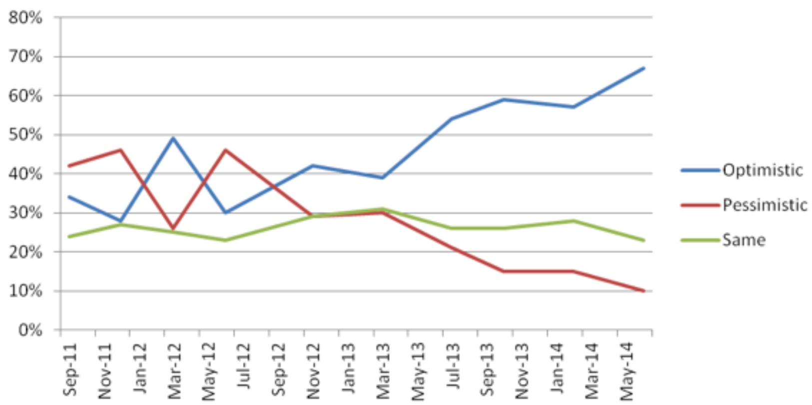
- Business confidence is 12 percentage points higher than the first survey in September 2011.
- 54% of businesses expect their activity to increase over the next year, a slight drop of two percentage points from the last survey in February 2014 but two percentage points higher than October 2013.
- The number of businesses who expect their activity to decrease over the next 12 months is at a record low: 3% expect their activity to decrease over the next year, a drop of three percentage points from the last survey and 12 percentage points since the first survey.



- 42% of businesses expect their business activity to stay at the same level, an increase of four percentage points.
- Larger businesses (those with more than 250 employees) are more likely to expect increased business activity than sole traders by a margin of 27 percentage points (69% larger businesses to 42% sole traders).
- Greater London remains the region with the highest level of business confidence (69%), whilst the South East has the smallest proportion of businesses that expect their activity to increase (36%).
- The Midlands region has the highest proportion of businesses that expect their activity to decrease (4%), followed by the North and South at 2%.
- Over half (51%) of the manufacturing industry expects business activity to increase in the next 6 months, an increase of three percentage points since the last survey.
- 56% of the services industry expect their activity to increase, followed by 54% of the retail and distribution industry.

Economic Optimism

- There is a significant increase in the proportion of businesses that are optimistic about the economy compared to the last survey in February 2014.
- 67% of businesses reported that they felt more optimistic about the economy than three months ago. This is an increase of ten percentage points from the last survey and still significantly higher than the first survey in September 2011 (34%).
- 10% of businesses are pessimistic about the economy: a decrease of five percentage points from the last survey and still significantly less than September 2011.
- Larger businesses are still more likely to be optimistic about the economy than sole traders: 69% of larger businesses are optimistic about the economy compared to 57% of sole traders.
- The levels of economic optimism are consistent around different areas of the country; 69% of businesses in the North are optimistic, followed by 67% in the Midlands and 66% in the South.
- The South East is the most pessimistic region: 19% of businesses in the South East are more pessimistic about the economy than three months ago.
- There is a significant increase in the proportion of businesses in the manufacturing industry that are more optimistic about the economy than three months ago: 70% - an increase of 13 percentage points from the last survey in February 2014. This is followed by the retail and distribution sector (67%) and services sector (66%).



Conclusion

Giles Frampton comments:

“Without doubt R3’s latest survey shows the majority of UK plc is experiencing a positive business landscape: most businesses are confident about their own prospects, optimistic about the economy as a whole, and show record high signs of growth and record low numbers of business distress.

Amongst this good news, however, it would not take much for this upward trend to be knocked off course. Businesses say the prospect of even a small interest rate rise might jeopardize their financial stability – with over one fifth of businesses saying they will be put into financial difficulty. Should there be a rise in the next few months, we should expect to see a change in some of the low numbers of results we are seeing.

A possible silver lining is that any such rise is likely to be small and gradual, enabling most businesses to plan accordingly and account for any such impact a rise might have.

You can be sure that we will be watching this very closely in the coming months.”

About R3:

R3, the insolvency trade body, represents 97% of insolvency practitioners. R3's members are 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. For more information please contact R3's Public Affairs and Policy Officer, Alex Green-Wilkes on **020 7566 4220** or **alex.green-wilkes@r3.org.uk**