Association of Business Recovery Professionals

R3

Rescue
Recovery
Renewal

Business DISTRESS Index

As the recession of 2008-09 fades ever-further away, the Government is looking to the private sector to drive the UK through early recovery to sustained growth.

But with the impact of the CSR yet to be felt in full and various policy changes (such as an increase in VAT) due to come in during the New Year, how are businesses faring? Evidence from previous recessions indicate that a return to growth is not the 'silver bullet' to financial health, with insolvencies tending to 'peak' some time after the official end of recession. So are businesses seeing the light at the end of the tunnel, or are more insolvencies likely as the recession's shadow and other conditions limit their chances of survival and expansion? Insolvency trade body R3 has launched the first of its quarterly tracking research intended to 'take the temperature' of the financial situation of businesses across Great Britain. The Distress Index will be tracked over time - a unique indicator of the financial health of businesses in Great Britain.

Executive Summary

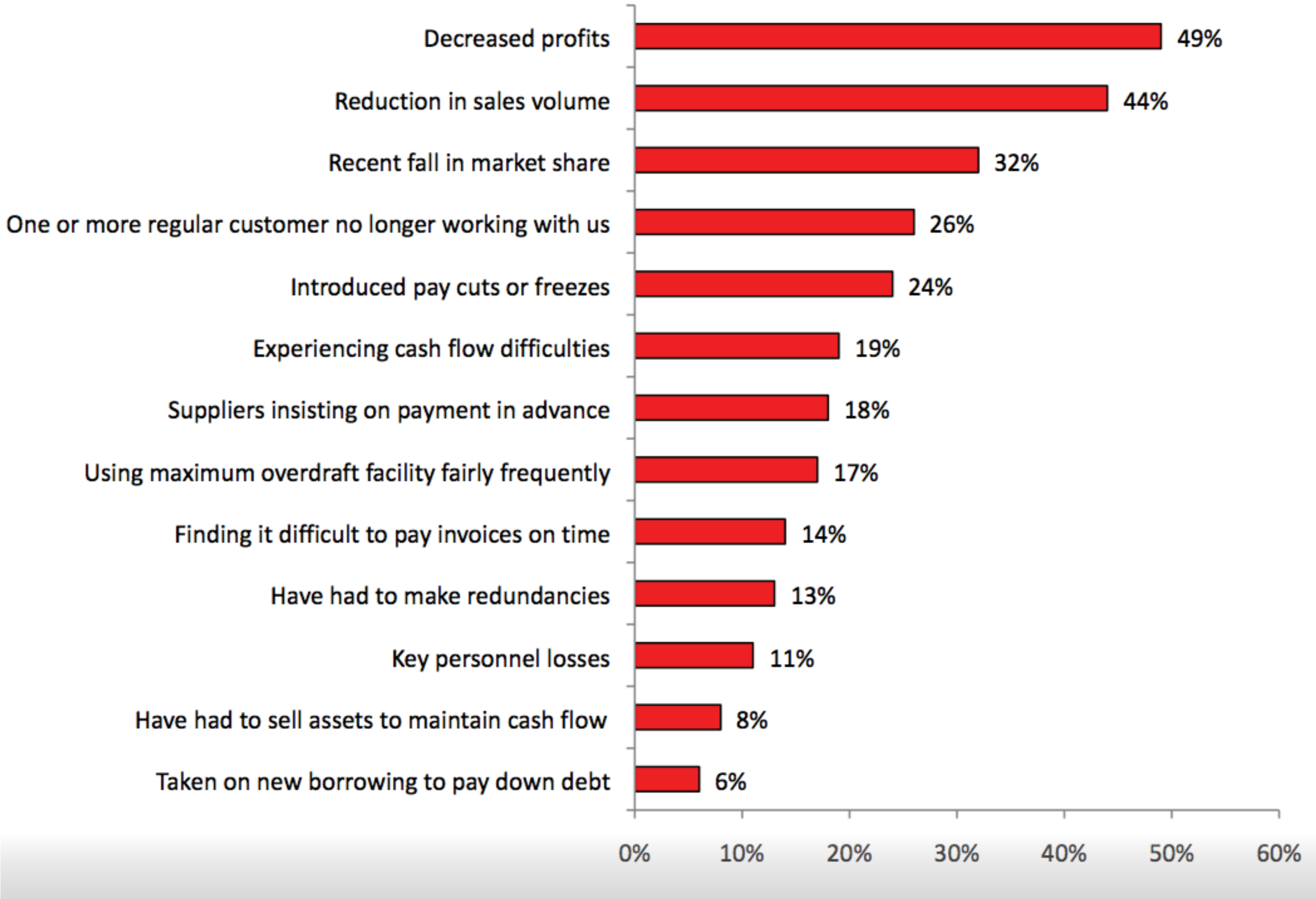
- R3 has identified key signs of business distress, using this survey as a way of identifying how many GB businesses have recently experienced each sign:
  - **Almost half of businesses say they are experiencing decreased profits (49%), and a similar proportion have seen a recent reduction in sales volume (44%).**
  - **A third (32%) say their market share has fallen recently, and over a quarter (26%) say one or more of their regular customers have stopped working with them. A similar proportion of businesses have had to introduce pay cuts or freezes (24%) and one in five (19%) admit to experiencing cash-flow difficulties.**
  - **18% of businesses say some of their suppliers are insisting on payment in advance, and 17% have been using their maximum overdraft facilit fairly frequently.**
  - **More than one in ten businesses (14%) are finding it difficult to pay invoices on time and a similar proportion have had to make redundancies (13%). 11% say one or more of their key personnel have recently left their company.**
  - **Just under one in ten (8%) have resorted to selling assets to maintain cash flow and 6% say they have taken the worrying step of taking on new borrowing to pay down existing debt.**
- Trends are similar among small and larger businesses, but small businesses are more likely than their larger counterparts to be experiencing cash flow difficulties and difficulties paying invoices on time (20% and 15% of small businesses, respectively). Larger businesses are more likely than small businesses to have made redundancies or have introduced pay cuts or freezes.
- **One in five businesses say they are worried about their current level of debt (19%)**. Concern about money owed to trade creditors tops businesses' debt concerns, particularly among small businesses.
- **Businesses perceive trade creditors as more supportive over the last 3 months than other creditor groups. Banks are seen by businesses as being, on the whole, supportive over this period, and they are viewed as more supportive than HMRC** (44% of businesses agree that banks have been supportive, while just over a third see HMRC in this way). However, 17% of businesses strongly disagree that banks have been supportive, suggesting the presence of a significant (and vocal) minority.
- Despite the varying signs of distress, **businesses are highly unlikely to believe they will fall into insolvency**. Just 3% perceive it as a likely outcome over the next 12 months.
- Distress signs and debt worry are often interlinked. The areas and sectors with a greater number of businesses worried about their debts are also those with a greater proportion saying they are experiencing at least one sign of distress:
  - **Debt worries are higher among businesses in the Midlands** compared to the other areas of the UK, with almost a third of businesses in this area saying they are worried about their current debt level. Businesses in the Midlands are also more likely to be experiencing signs of distress than those elsewhere in the UK (with 81% experiencing one or more signs of distress).
  - **Debt worry is also higher among businesses in the manufacturing sector** than in other key sectors (29% are worried, compared to 18% of those in distribution sector, and 14% of those in the service sector). Businesses in this sector are also more likely to say they are experiencing at least one sign of distress than those in other key sectors.

Methodology note: BDRC Continental conducted 500 telephone interviews with small, medium and large business owners and FDs between 6th and 17th September 2010. Quotas are set by size, region and sector and the data weighted to the profile of GB businesses. The respondent in each case is a senior financial decision maker. Where figures are mentioned, estimates have been extrapolated using the percentages from the results and the number of businesses for Great Britain. Small businesses are those with a turnover of £50,000 to £1million pa; medium and large businesses are those with a turnover of more than £1million pa.

Signs of distress

R3 has identified key signs of business distress, using this survey as a way of identifying how many GB businesses have recently experienced each sign.

Almost half of businesses say they are currently experiencing decreased profits (49%) and a similar proportion (44%) say they have recently seen a reduction in sales volume. A third of businesses (32%) say their market share has fallen recently, and over a quarter (26%) say one or more of their regular customers have stopped working with them.



A similar proportion (24%) have had to introduce pay cuts or freezes and one in five (19%) admit to experiencing cash-flow difficulties. 18% of businesses say some of their suppliers are insisting on payment in advance, and 17% have been using their maximum overdraft facility fairly frequently. More than one in ten businesses (14%) are finding it difficult to pay invoices on time and a similar number have had to make redundancies (13%). 11% say one or more of their key personnel have recently left the company. Just under one in ten (8%) have resorted to selling assets to maintain cash flow and 6% say they have taken the worrying step of taking on new borrowing to pay down existing debt.

R3 has extrapolated the figures to provide an indication of how many businesses are experiencing each sign of distress:

Distress sign	Number of businesses
We are experiencing decreased profits	854,000
We have seen a reduction in sales volume	751,000
Our market share has fallen recently	548,000
One or more of our regular customers has stopped working with us	451,000
We have had to introduce pay cuts or freezes	419,000
We are experiencing cash flow difficulties	321,000
Some of our suppliers are insisting on payment in advance	315,000
We have been using our maximum overdraft facility fairly frequently	293,000

Continued...

Distress sign	Number of businesses
We are finding it difficult to pay invoices on time	240,000
We have had to make redundancies	229,000
One of more of our key personnel has recently departed	182,000
We have had to sell assets to maintain cash flow	139,000
We have taken on new borrowing to pay down existing debts	107,000
We are experiencing at least one of these	1,291,000

R3 President Steven Law explains:

*"**A significant proportion of businesses are experiencing key distress indicators**. This suggests that the after-effects of the recession continue to impact on many businesses. Although the economy has returned to growth, many businesses are not 'out of the woods' yet. With certain changes in conditions expected, it is likely that - when we look back on 2010 - we will see this period as the calm before the storm. **As interest rates surely rise, the cost of servicing debt increases, and creditors become more determined to retrieve their money, weakened businesses are likely to lose their battle for survival and insolvencies will rise**.*

*The top few signs of distress are inextricably linked: losing major customers usually results in a decreased market share, which generates fewer sales and brings about a decrease in profits. This can lead businesses to introduce pay cuts/freezes or even bring in redundancies to decrease costs for the business. Decreased profits usually also represents an increase in a business's cash needs. Although this state of affairs may be fine for a short period of time, it is not sustainable. **Businesses need an increase in profits to ease or avoid cash flow troubles - if this does not happen, the business may be damaged irreparably.***

*A further consequence of decreased profits is that businesses will often find it harder to secure bank funding. This can result in the owners drawing on personal funds instead, putting them at significant risk of personal insolvency if the business eventually fails. In fact, it may be surprising that a smaller number of businesses are experiencing cash flow problems given that so many are experiencing decreased profits. This may indicate that these **businesses are stretching their creditors or injecting other (perhaps personal) funds into the business**. Again, while this can work for a short period of time, it may not be sustainable.*

*A significant minority of businesses have seen their suppliers insisting on payment in advance and a similar number are frequently drawing on their overdraft facility. **Insisting on payment in advance demonstrates a considerable lack of trust in the business's performance and longevity**. Frequently drawing heavily on an overdraft could indicate that the overdraft has become 'hardcore', with the normal pattern of business fluctuation lost.*

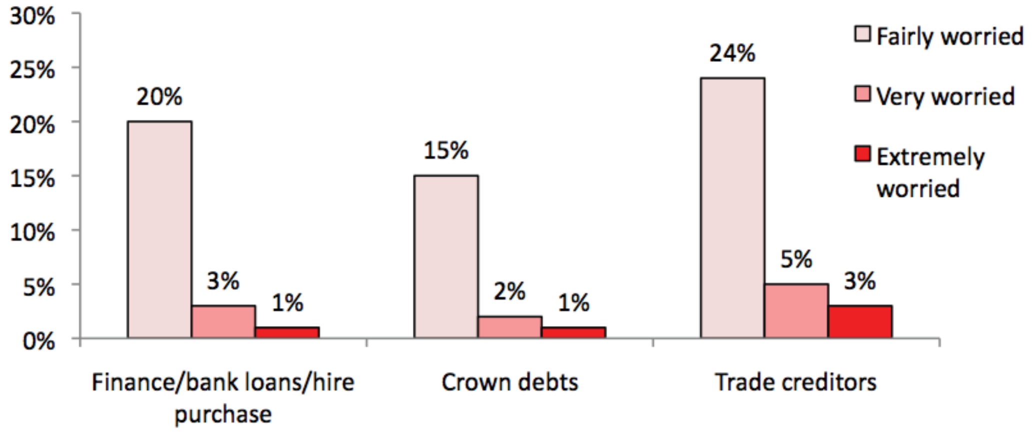
*When a business is in financial trouble, there is usually a tangible change in atmosphere. Creditors, customers and suppliers demand information and reassurance about the company's financial situation, management spend their time fire-fighting rather than managing, and fear spreads among the employees. All too quickly, **the business can develop a demoralising character**. Even if the company takes steps to resolve its financial difficulties, it can take a long time for the business's character to be restored to pre-crisis.*

*Almost one in ten businesses (8%) are selling assets to maintain cash flow. This can be a good decision if the assets are surplus to requirements. However, **if selling assets reduces efficiencies, it is a worryingly short-sighted policy** that only escalates financial difficulties in the long run."*

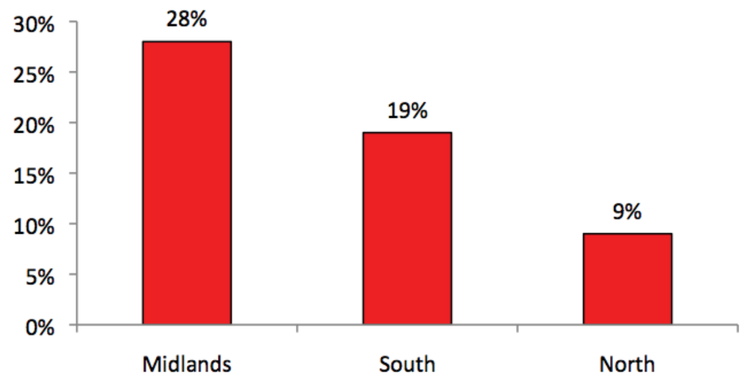
Business debt fears

Of the 500 businesses surveyed, 57% do not have any debt at all (finance, bank loans, crown debts, trade creditors). 24% say they are 'not at all' worried about their current level of debt in their business; 16% are 'fairly worried', 2% are 'very worried' and 1% are 'extremely worried'. All in all, 19% of businesses are worried about their current level of debt.

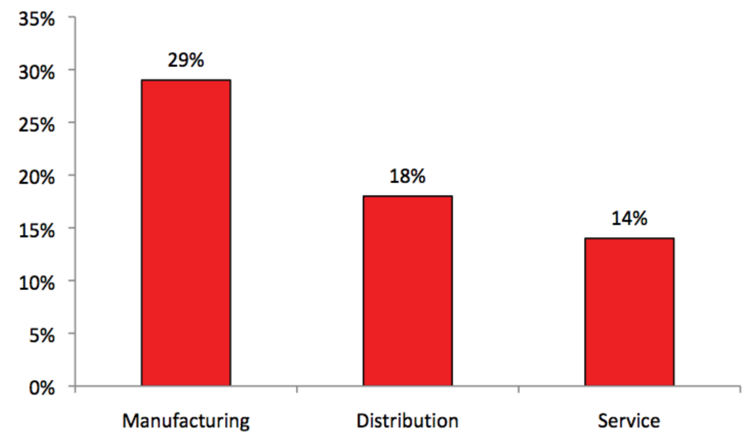
Worry about debts to trade creditors tops businesses' concerns, with around a third (32%) of businesses describing themselves as worried about the amount of debt they owe to trade creditors. Concerns about finance/overdraft/bank loans and hire purchase are felt by a quarter of businesses (24%); while 18% say they are worried about Crown debts (such as PAYE or VAT).



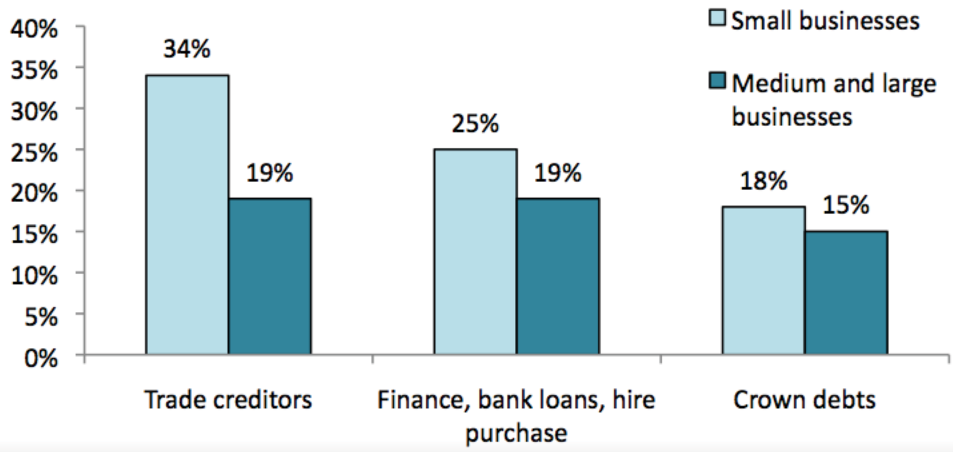
Worry about current debt levels is highest among businesses in the Midlands, with 28% describing themselves as worried. This compares to 19% of those in the South and just 9% of those in the North.



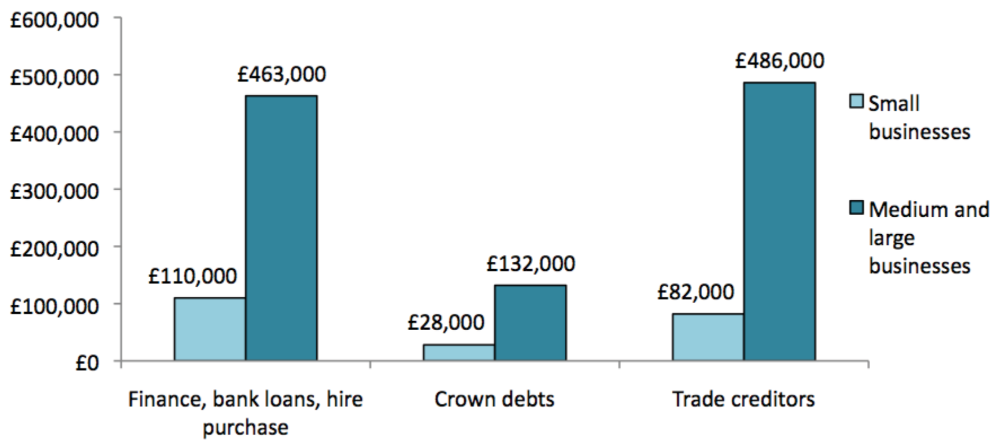
Businesses in the manufacturing sector are more concerned about their current level of debt than those in the distribution and service sectors (at 29%, 18% and 14% respectively). Debt concern is highest in the construction and manufacturing industries, with around a third of businesses describing themselves as worried about the amount of debt they currently owe. Concern is lower among other industries; though worry about debts still affects more than one in ten businesses in other key industries.



A greater proportion of smaller businesses are worried about their trade debts than their medium and large counterparts (34% and 19%, respectively). By contrast, worry about bank finance and crown debts are more similar across business size.



Businesses tend to owe a greater amount in finance, banks loans/overdraft and hire purchase and to trade creditors than they do to HMRC. The following graph shows the average amount currently owed to key creditor groups by size of businesses:

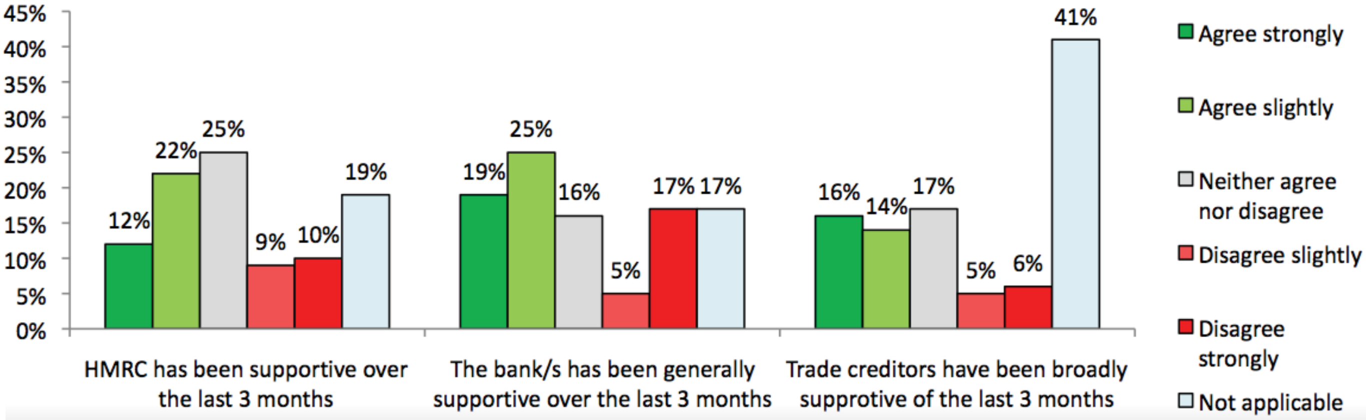


R3 President Steven Law explains:

"Businesses' concerns about debts owed to creditor groups tends to mirror the amount they owe - with worry about debts to trade creditors and secured creditors outstripping concerns over crown debt. Debts owed to trade creditors can often weigh particularly heavily because businesses usually deal with these creditors on a day-to-day basis. They may be more obvious and tangible than debts owed to the bank, which can seem more remote."

Recent creditor behaviour

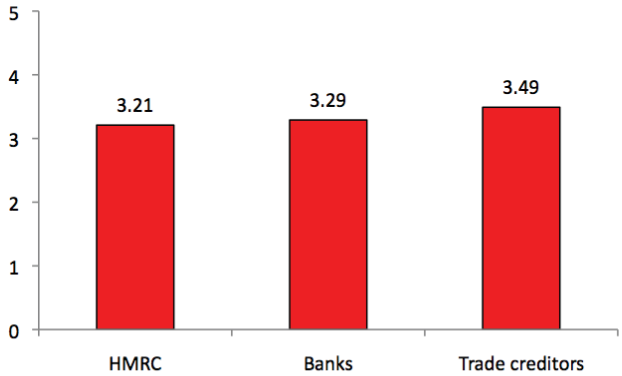
Over a third of businesses believe that HMRC have been broadly supportive over the last 3 months, (net agreement is at 34%, while net disagreement stands at 19%). A significantly higher proportion of businesses describe the banks as broadly supportive over the last few months (44%), while 22% disagree. In fact, 17% of businesses ***strongly*** disagree that banks have been supportive, suggesting the presence of a significant and vocal minority in the business community.



Around a third of businesses (30%) believe trade creditors have been supportive over the last quarter, with just 11% saying this has not been their experience. The proportion of businesses that cannot comment on creditor behaviour (those who select 'not applicable' in each case) indicates that businesses may have had more interaction with the banks and HMRC than they have done with trade creditors over the last 3 months (where 'not applicable' stands at 41%).

In order to facilitate analysis, mean scores were calculated by assigning numerical values to the responses, where 'disagree strongly' equates to 1 and 'agree strongly' equates to 5 ('not applicable' has not been awarded a value). The difference between mean scores is minimal; however the results indicate that businesses perceive trade creditors as marginally more supportive than other creditor groups (at a mean score of 3.49). Banks come in second, at 3.29, followed by HMRC at 3.21.

Mean scores awarded to each creditor group



R3 President Steven Law explains:

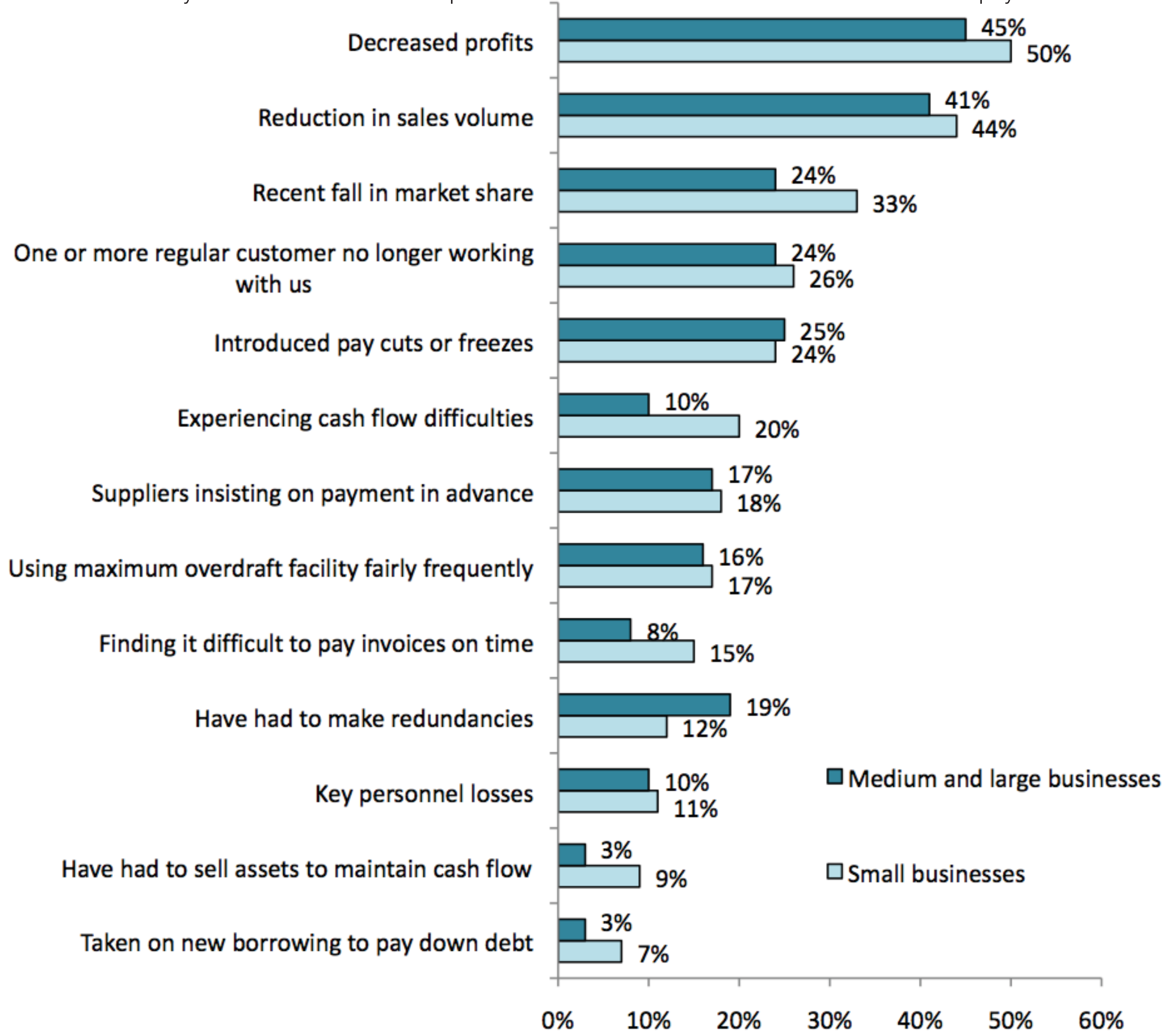
"Creditor actions can have a significant impact on business survival and insolvency trends. Their behaviour through the recession and into 2010 has certainly played a key role in stemming the tide of insolvencies. We've seen historically low interest rates keeping the cost of servicing debts relatively low, HMRC's Time to Pay and other tax-deferral schemes allowing businesses breathing space to pay their taxes, and - in marked change to previous recessions - secured creditors, like the banks, adopting a much more supportive approach towards business in difficulty.

"Despite the negative tone of much public debate around bank behaviour, I have seen a significant difference in the approach of the banks compared to their behaviour during the 1990s. In comparison to the swiftness with which banks often appointed administrative receivers during the previous recession, banks have been working with businesses this time around - granting holidays on loan payments, extending loan periods, and granting further advances. While there may be certain instances in which viable businesses are not sufficiently supported by the banks, my experience generally chimes with that of businesses themselves – on the whole, banks have demonstrated a supportive rather than aggressive attitude towards the business community.

"However, as conditions change, so too will the approach of major creditors. If interest rates rise and the cost of servicing debt grows, businesses will become less viable and banks may seek repayment. Time to Pay will also begin to be withdrawn as HMRC strives to recoup deferred tax payments. Businesses so far have generally benefited from supportive creditors, but this approach will not last forever."

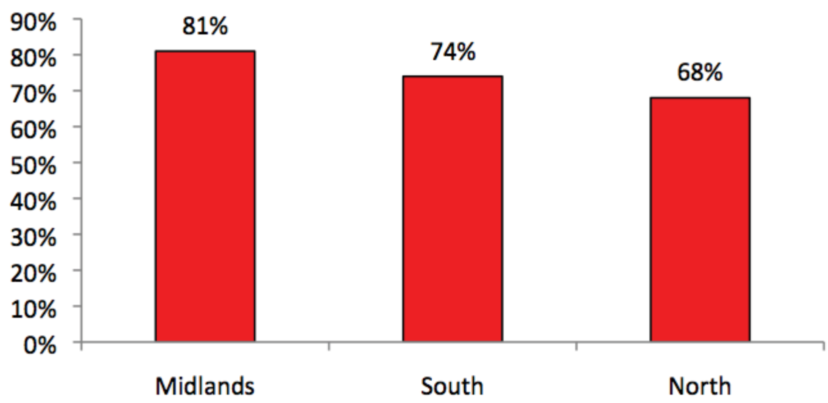
Signs of distress by key demographics

Patterns are similar among small and larger businesses, but there are some noteworthy differences. While one in ten larger businesses are experiencing cash flow difficulties, 20% of small businesses say this is currently affecting them. Similarly, while 8% of larger businesses are struggling to pay invoices on time, this applies to 15% of small businesses. Perhaps unsurprisingly, larger businesses are more likely than their smaller counterparts to have made redundancies or have introduced pay cuts or freezes.

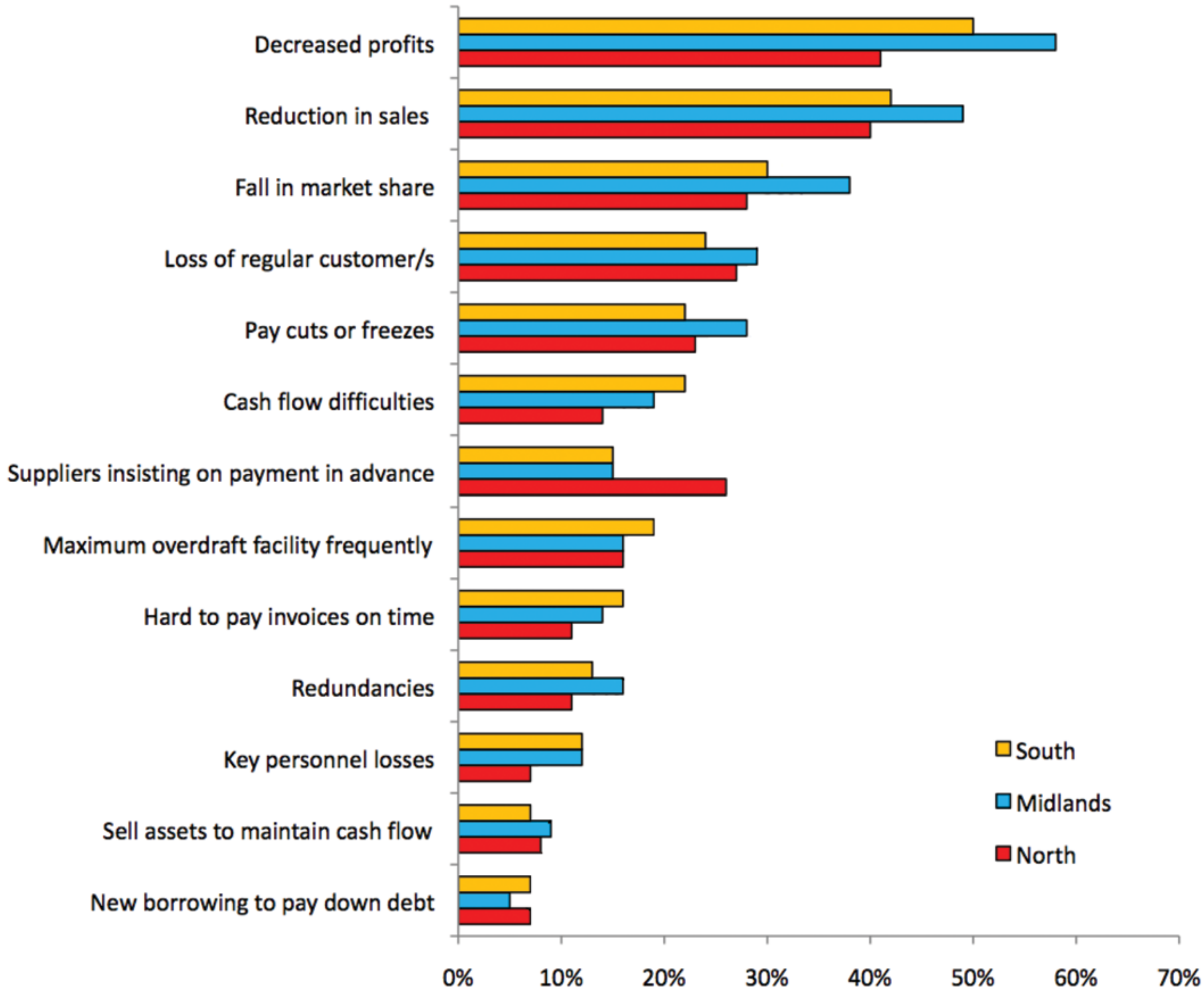


The adjacent graph shows the number of businesses in each area that are currently experiencing one or more signs of distress. It indicates that businesses in the Midlands are more likely to be experiencing signs of distress than those elsewhere in the UK (with 81% experiencing one or more signs); while those in the North are least likely to say they are experiencing signs of distress (at 68%).

Number of business experiencing one or more sign of distress, by region

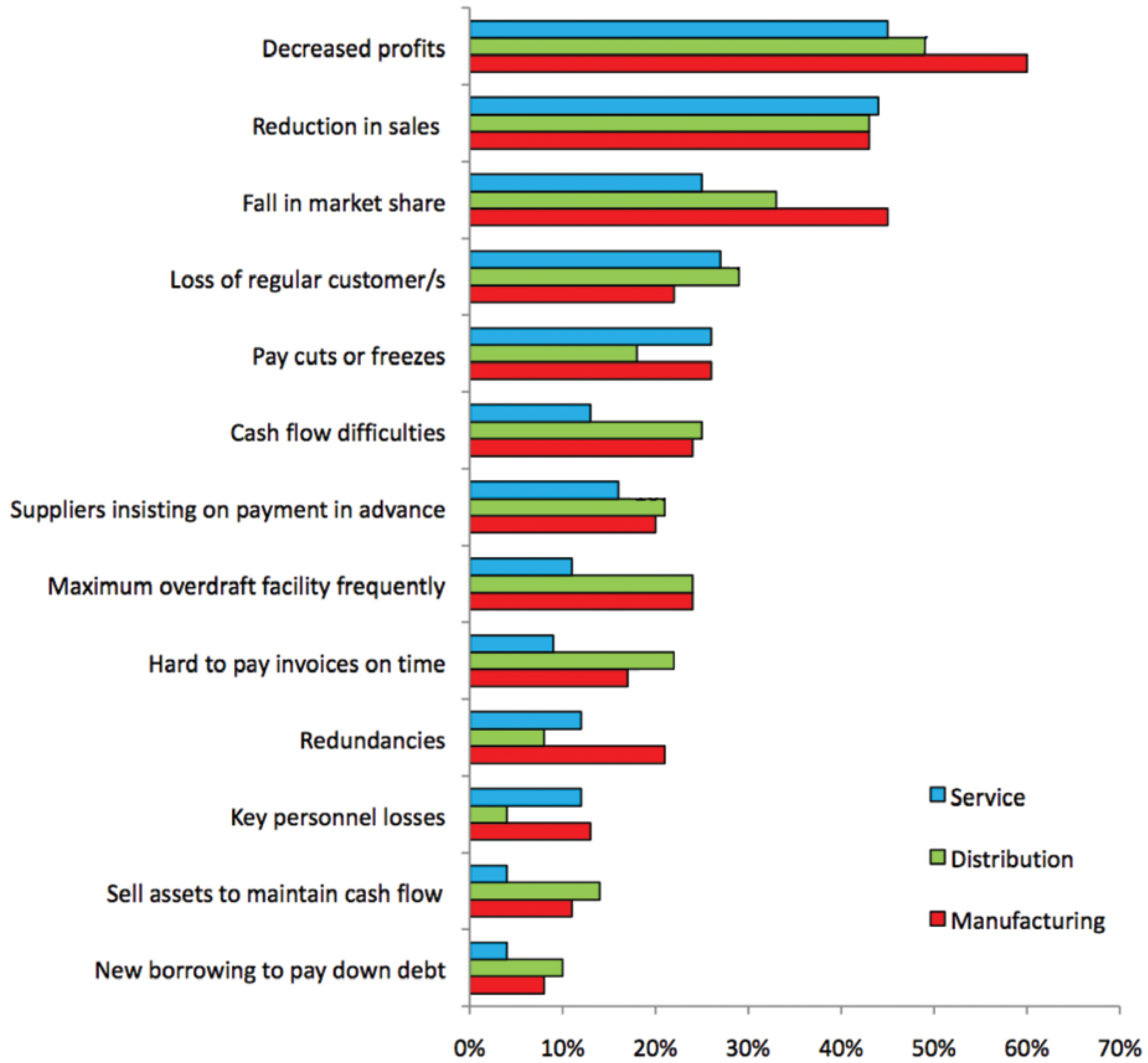


The most commons signs of distress (decreased profits, reduction in sales volumes, fall in market share, loss of regular customers and pay cuts/freezes) have affected a greater proportion of businesses in the Midlands than those in other regions. For example, 58% of businesses in the Midlands say they are experiencing decreased profits at the moment, compared to 50% of those in the South and 41% in the North.



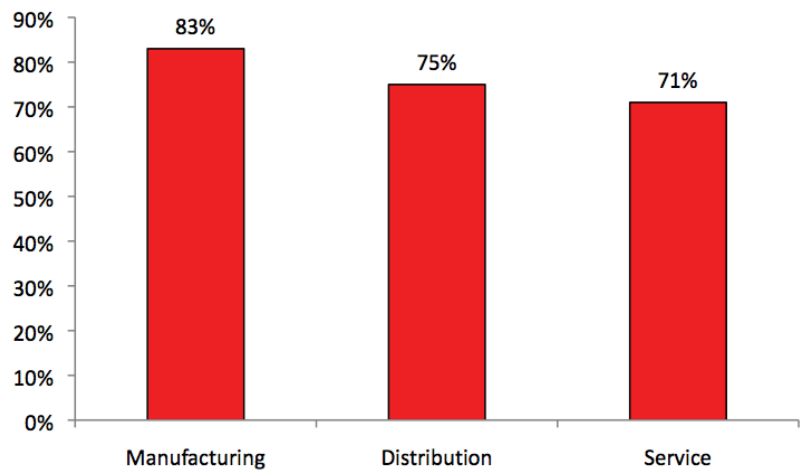
Although businesses in the North often trail the other regions in the proportion of business experiencing many signs of distress, they are comparatively more affected by suppliers insisting on payment in advance, with over a quarter of businesses in the region saying they are experiencing this (26%).

The following graph shows the number of businesses in each sector that are currently experiencing one or more signs of distress. Businesses in the manufacturing sector are more likely than those in other sectors to have experienced a recent decrease in profits (60%) and fall in market share (45%), with those in the service sector least likely to have done so. However, a reduction in sales and loss of regulator customers is relatively similar across sectors. A greater proportion of businesses in the distribution and manufacturing sectors have recently experienced cash flow difficulties, suppliers insisting on payment in advance, and frequent use of maximum overdraft facility.



On the whole, businesses in the manufacturing sector tend to be more likely to exhibit signs of distress than those in other key sectors (at 85%, compared to 75% of distribution businesses and 71% of those in the service sector).

Number of business experiencing one or more sign of distress, by sector

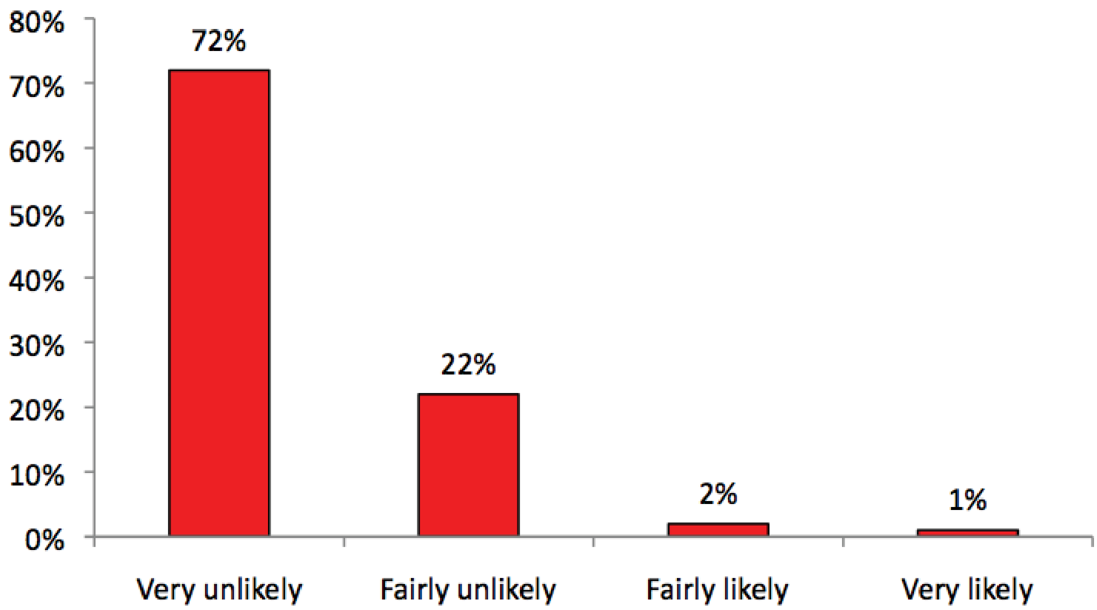


R3 President Steven Law explains:

'Businesses in the manufacturing sector and the Midlands are more worried about their debt - and more likely to have experienced distress - than those in other sectors or elsewhere in the country. Manufacturing accounts for a considerable proportion of GVA and a significant degree of employment in the Midlands. The results suggest that many businesses in the manufacturing sector (and consequently the region) are still feeling the effects of the recession and are struggling to restore profitability. The manufacturing sector grew at its slowest rate in 10 months in September, which suggests that the sector's recovery may be stabilising. The future of many businesses within the sector are not yet secure."

Perceived likelihood of insolvency

Despite the varying signs of distress, businesses are highly unlikely to believe they will fall into insolvency. 72% believe this possibility is very unlikely; 22% think it is fairly unlikely; and just 3% perceive it as a likely outcome.



R3 President Steven Law explains:

"Running a business requires determination, drive and optimism. While optimism can be a great quality, businesses must be careful not to be blind to signs of distress. Picking up on these indicators and being conscious of problems as they arise enables management to take swift action rather than letting problems escalate. Seeking professional advice is not a sign of weakness - if sought at an early stage, it can mean the difference between business survival and decline."

Practical tips for avoiding corporate insolvency

1. **Don't max-out the business overdraft each month.** Coming out of the recession make sure you have sufficient capital reserves to take advantage of opportunities. Have either cash reserves or access to borrowings through your bankers.

2. **Produce a business plan with forecasts.** A business plan gives strategic focus to the business. Ensure that actual performance is monitored against forecast.

3. **Pay accounts on time, not on receipt of writ, and benefit from discounts** Late payment of bills sends out a clear sign to suppliers who will eventually grow weary of your ways and may refuse to supply. Pay on time to take advantage of early payment discounts and create goodwill with your supplier. If you are not able to pay, seek an extension from your supplier.

4. **Impose strict credit control and debt collection procedures of your own. Guard against the domino effect.** Only deal with customers who will pay their debts. Insolvency Practitioners estimate that 27% of corporate insolvencies are triggered by another company's insolvency. Make sure you have a broad customer and supplier base, as relying on a few customers could be crippling if they default on payments or fail. If your debtors are not paying on time, chase them up.

5. **Stay up-to-date with all crown payments.** If you have cash flow problems ask for a 'time to pay' arrangement from HM Revenue & Customs. So far they have been sensitive to the needs of business in this recession. However this must be viewed as only a short term fix - money deducted from salaries and VAT does not belong to the business.

6. **Don't hold a large amount of stock in relation to turnover/ profit.** In the upturn the challenge is to have the stock to supply the needs of your customers promptly; this is when you will need to carry some stock. But see if you can arrange 'just in time' supplies with your key component suppliers as it will minimise stock carrying costs.

7. **Is your accounting system fit for purpose?** Have a system which produces the information you want on a timely basis. Also, be on good terms with your bank manager, keep them informed of developments whether good or bad and provide management figures regularly.

8. **Don't put off seeking professional help** The sooner a business in difficulty seeks professional advice the greater their long-term chances of survival. Seek professional advice from a regulated professional or reputable trade organisation as soon as possible. An insolvency practitioner usually offers their first hour of advice free.

9. **Don't put personal assets at risk** Avoid committing personal assets to the business without taking independent advice first.

10. **Review for underutilised assets and unnecessary costs** Assets should be made to sweat and work for the business. Surplus assets should be sold to generate cash. Costs savings will also enhance cash flow.

About R3

R3, the trade body for Insolvency Professionals, represents over 97% of Insolvency Practitioners. R3 members are trained and regulated accountants and lawyers who have extensive experience of helping businesses and individuals in financial distress.