SMEs make up ground

THE UK'S SMALLER BUSINESSES ARE PROVING MORE RESILIENT THAN MANY APPRECIATE, SAYS **PAUL WHITMORE**.

There appears to be a consensus that the UK's economic recovery depends on paying greater attention to manufacturing and, in particular, improving funding to small and medium-sized enterprises (SMEs).

With the banks castigated for the failure of Project Merlin to achieve that aim, chancellor George Osborne indicated in early October that the government would instead introduce a programme of "credit easing" to improve the flow of money to small business. This was swiftly followed by the Bank of England reviving its quantitative easing programme, with an injection of a further £75bn, taking the total to £275bn. The newly launched Shawbrook Bank, financed by RBS Equity Finance, is the latest in a series of initiatives to ease the lending drought affecting smaller businesses.

The struggles of Britain's SMEs contrast with the apparently better fortunes of their peers in Germany, where three million Mittelstands, as SMEs are referred to in the country, account for more than half German exports and 70% of the workforce. Mittelstands are held up as exemplary, with the family ownership or control common to many resulting in a focus on long-term performance. They have helped Germany emerge from recession more quickly than its neighbours and resume a pace of economic growth that has only recently begun to falter.

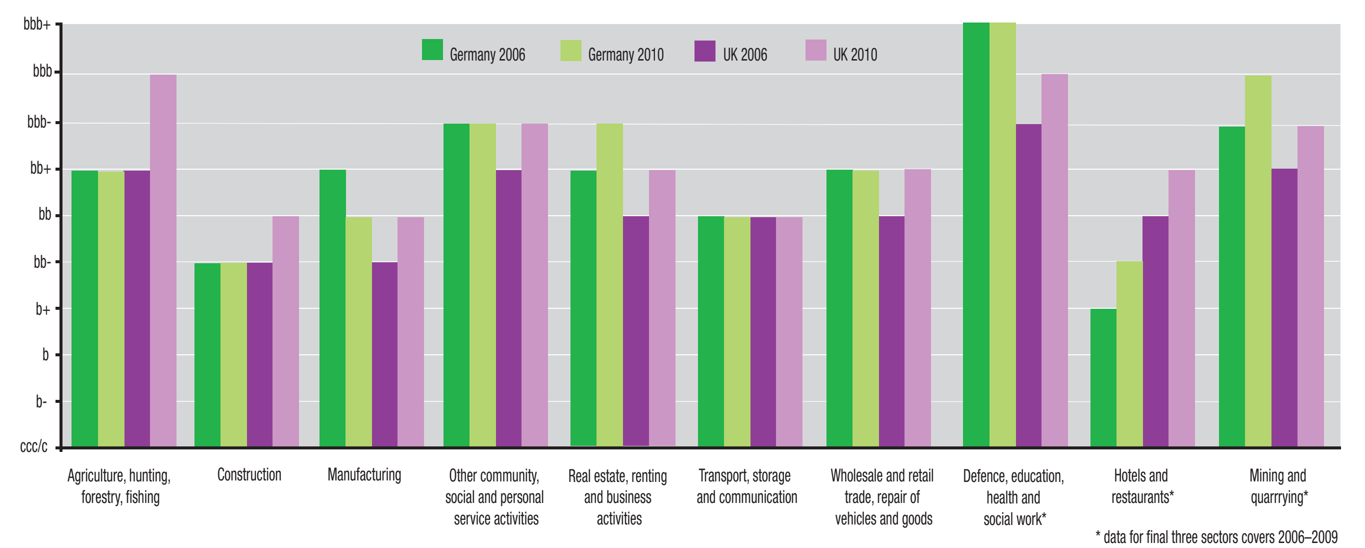
CASH PILES BUILT UP Yet the picture is not as black and white as media reports might suggest. Many of the UK's SMEs have, through necessity, amassed substantial cash piles as a hedge against hard times and looked beyond the banks to alternative sources of funding. A study of the credit quality of a subset of SMEs across the UK over the past five years reveals that it has improved since 2006. Compared with their counterparts in Germany, there is evidence that SMEs in the UK have improved their position and narrowed the gap with Europe's strongest economy.

The evidence is based on the annual financial statements of a subset of privately owned German and UK companies with annual turnover under €50m or £50m respectively, combined with macroeconomic variables. The SMEs surveyed were taken from 10 different sectors:

- agriculture, forestry and fishing;
- mining and quarrying;
- manufacturing;
- construction;
- wholesale and retail trade, goods and vehicle repairers;
- hotels and restaurants;
- transport, storage and communications;
- real estate, renting and business activities;
- defence, education, health and social work; and
- miscellaneous.

A comparison of the one year modelled probability of default (PD) for SMEs in the two countries indicates that in the UK the PD across each of the 10 sectors increased in

Figure 1: Median quantitatively derived creditworthiness scores for UK and German SMEs, 2006–2009/10, by sector



2007 but has since declined. In Germany the median modelled PD for 2007 showed little change from the previous year, suggesting that the credit crunch that steadily developed that year had relatively little impact on its small businesses.

Another comparison looked at default frequencies from Standard & Poor's annual default ratings study, to assess the quantitatively derived creditworthiness score for each sector.

This showed that the subset of SMEs in nine of the 10 sectors in the UK improved their creditworthiness between 2006 and 2009/10, with transport, storage and communications the only exception, remaining unchanged (see Figure 1).

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A STRONG SHOWING This overall performance compares well against Germany's. In 2006, the median creditworthiness of German SMEs was superior to those of their UK counterparts in six sectors, while a further three showed level pegging. This picture had changed significantly by 2009/10, by which time the effects of the credit crunch and the global economic downturn were evident. Four sectors shared level pegging, in three others the creditworthiness of UK SMEs was superior to German SMEs and only in three others did Germany still have the edge.

Over the period, the two UK sectors showing the most marked improvement in median creditworthiness were the hotels and restaurants sector and agriculture, forestry and fishing. The creditworthiness of small businesses in the UK's manufacturing sector, which lagged some way behind Germany's in 2006, had caught up by 2009/10. The UK's defence, education, health and social work sector also made up ground over the same period, although not enough to draw level with Germany.

The comparison could lend some weight to the contention by UK banks that lending volumes to SMEs have eased largely due to lack of demand. Harder times could have been the catalyst for many small businesses to improve their cash management and either conserve their funds or tap new, less traditional sources of investment. However, many may simply be reluctant to invest for the future. This bolsters creditworthiness in the short term, but does not augur well for the UK's longer-term economic prospects.

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