

ECONOMIC REPORT

March 2011
Issue No.6 (2010Q3- 2010Q4)

- total advances
- additional funding available
- additional facilities agreed

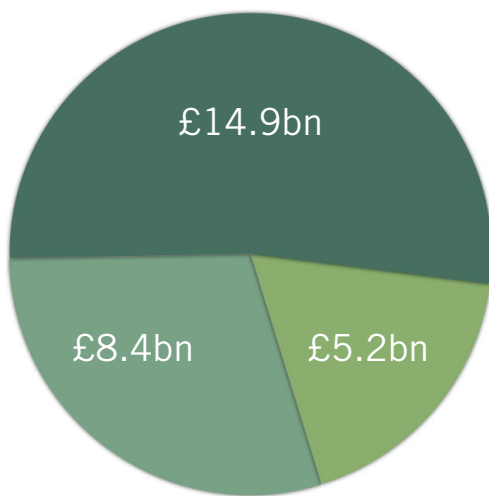


CHART 1: Total advances and additional funding available (£bn)

Source The ABFA

ADVANCES BY ASSET BASED LENDERS INCREASE, WITH FURTHER SUPPLY AVAILABLE

ABFA STATISTICS

- Total advances to UK firms in 2010Q4 rose to £14.9 billion, an 8% rise.
- More than £4bn has been made available to nearly 35,000 small and medium sized businesses in the UK this quarter.
- Client turnover saw a rise of 12% and annualised figures are now at a pre-recession record level of £212.2 billion.
- Members in Ireland have advanced an additional 4% to make €1.3bn of asset based finance available in 2010 Q4.

Advances to clients stand at £14.9bn, with a further £5.2bn of unused facilities available to clients based on existing sales invoices, and a further £8.4bn available if sales grow.

"It's great to see that lending to SMEs and larger businesses from members is rising and, even better, that turnover from clients using invoice finance is at pre-recession levels. The figures clearly show that this type of lending is definitely accessible and SMEs should be aware that there are funding options very much available to them."

Kate Sharp, CEO

ECONOMIC CONDITIONS

- Growth at 1.5% has been lower and more variable than expected.
- Sales and orders are improving, but demand is weak.
- Surveys indicate less unused capacity in the economy.
- Inflation has reached 4% and is forecast to peak at 5%.
- Interest rate increases may threaten the recovery.
- The earthquake in Japan has added further uncertainty to demand and supply conditions.

More on page 4.

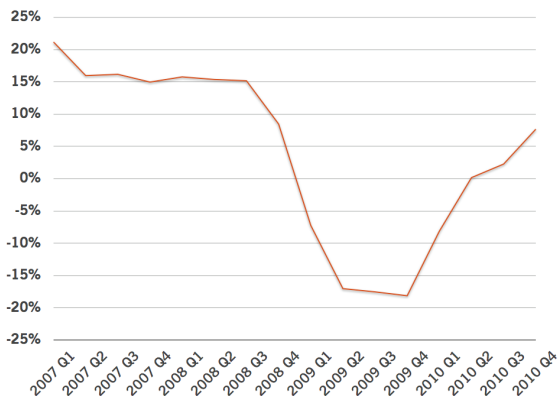
CREDIT CONDITIONS

- Surveys of Lenders report improvements to the availability of credit to the corporate sector as a whole.
- The British Bankers' Association reports a decline of 4.3% for term lending and 10.2% for overdrafts.
- Cash balances of small businesses have grown by £3.6bn.
- Loans in sterling to UK businesses fell by 3.9% over the year to 2010Q4.

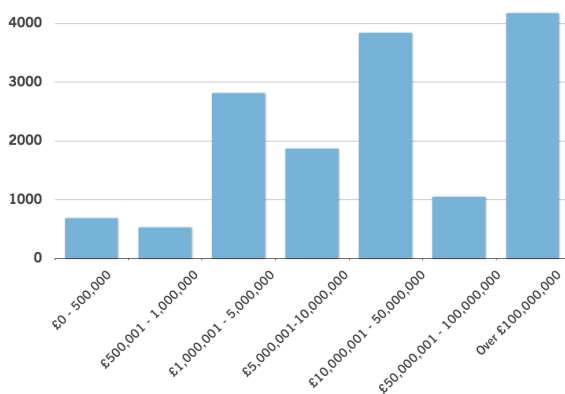
More on page 3.

CHART 2: Growth in total advances (%)

Source The ABFA

**CHART 3:** Advances to clients by client size (turnover) £mn

Source The ABFA



ASSET BASED FINANCE STATISTICS

ADVANCES

Total advances from Members in 2010Q4 rose to £14.9 billion, which is an 8% increase on the figures a year ago. The total funding available to firms, based on approved invoices in their sales ledger and the percentage of the ledger that is available as asset based finance is £20.1bn. This is the total supply that has been approved by the asset based finance association members to firms seeking asset based finance. The utilisation rate of available supply is therefore 74.1%, with a further £5.2bn of finance available and approved for use. As firms' sales ledgers grow and their invoices increase, ABFA members extend the facilities available to their clients. The total facilities agreed in 2010Q4, which could be regarded as an upper limit on the funding available if growth in turnover occurs, is £28.6bn. If sales and orders continue to expand, as many firms are reporting this quarter, then a further £13.6bn of asset based finance is available for firms with growing turnover. The growth in advances is now strongly positive after the decline during the recession (see Chart 2).

BREAKDOWN OF ADVANCES

The breakdown of client numbers and advances by size of client turnover shows that much of the funding available is offered to smaller and medium sized businesses. Over half of the businesses receiving asset based finance are small businesses with turnover below £1m. A further 34% of firms are medium sized, and together SMEs receive over £4bn in advances from ABFA members. Chart 3 shows the breakdown of advances by client size.

TURNOVER

Turnover from companies using invoice finance this quarter also shows a healthy rise of 12% and annualised figures are now at the pre-recession level of £212.2 billion. The largest components of turnover are domestic invoice discounting, domestic factoring and export invoice discounting. These have grown by 11%, 6% and 39% respectively, recording client sales of £47.5bn, £4.6bn and £3.5bn.

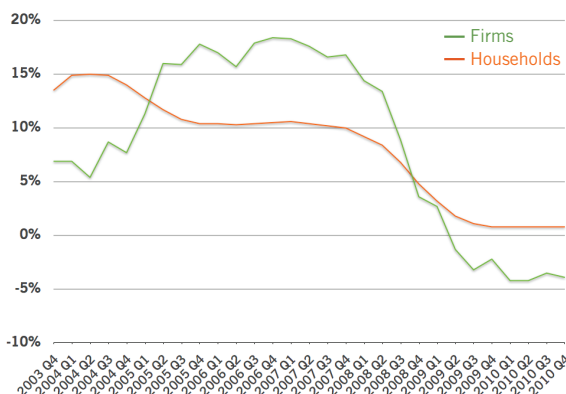
CREDIT PROTECTION PAYMENTS

The scale of credit protection payments to clients, has fallen by 17% to £5.2bn in the quarter. These payments are made by the asset based finance industry to their clients when their customers default on debt receivables where a non-recourse facility is in place. The payments amount to £25.2mn for the full year, which is a large fall from the £36.1mn paid out in 2009, and represents a return to pre-crisis levels. The fall in the number of companies becoming insolvent, and the lower default rate on loans from the major banks, all point to lower risk for lenders. The lower figure also reflects the tightening of limits by credit protection providers during the recession.

DEBTOR DAYS

ABFA figures on the average number days debts outstanding have fallen to 57.4 for factoring clients and 56.4 for invoice discounting clients. During the recession the debtor days for both groups peak at 70 and 63 respectively. Businesses are therefore waiting fewer days to receive payment on debts and sales invoices as ABFA members have worked harder to follow up invoices outstanding.

CHART 4: Percentage change in lending to firms and households
Source Bank of England



BANK LENDING AND CREDIT CONDITIONS

FACTORS CONTRIBUTING TO DEMAND FOR LOANS THIS QUARTER

SOURCE: BANK OF ENGLAND

Positive

- Merger and acquisition activity
- Inventory finance
- Balance sheet restructuring

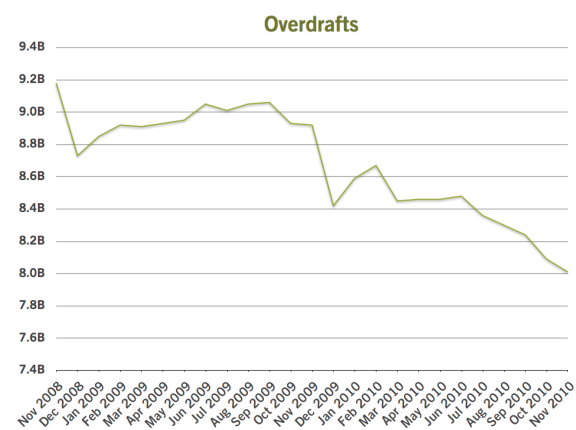
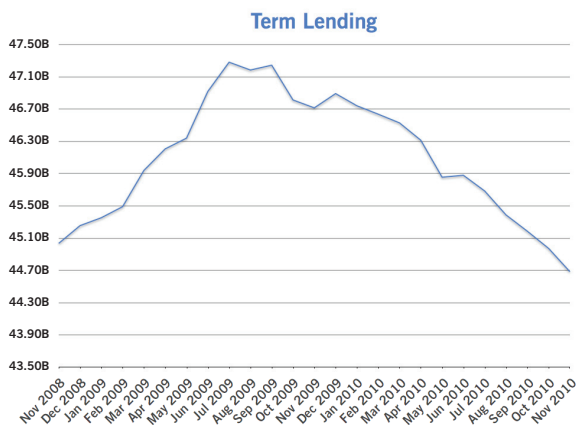
Neutral

- Capital investment

Negative

- Real estate purchases (commercial)

CHART 5: Lending and overdrafts to small businesses
Source BBA



BANK LENDING

Credit availability has improved, but the latest figures for lending by the major UK lenders to businesses shows that lending has continued to contract. This is particularly so for small and medium sized businesses that have relatively weak demand for credit and are still repaying more credit than they are taking out in new borrowing. Loans in sterling to UK business fell by 3.9% in 2010Q4 compared to 2009Q4; in 2007 before the financial crisis occurred, credit growth to businesses as a whole was 16.6% year-on-year (see Chart 4).

The decline in borrowing can be traced to several economic causes. Although sales and orders appear to be improving, the weakness of demand for goods and services and spare capacity in the UK economy, means that firms are not inclined to expand activity or invest in additional production. Small businesses have focused on repaying loans and building cash buffers, while larger firms have reduced bank borrowing while simultaneously increasing their net issuance of equity in 2010Q4. Share issues have risen by £400mn as greater investor appetite in the search for yield has enabled firms to issue shares and reduce their debt-equity ratios. The *Deloitte CFO Survey* of very large companies suggests that firms regarded the scale of bond issuance in 2009 to have increased leverage to unacceptable levels, prompting them to rebalance in 2010. Some decline in borrowing is due to the contraction in particular sectors, such as commercial real estate, and SMEs in general are borrowing much less than they were a year ago. The figures reported for term lending and overdrafts to small business show a decline of 4.3% for term lending and 10.2% for overdrafts, due to repayments exceeding the scale of new lending (see Chart 5), although there has been an average monthly increase in new term lending of £550mn. These same firms have rapidly growing deposits with the major UK lenders: cash balances have grown by £3.6bn over the year.

COST OF CREDIT

Separating the costs of credit into fees and spreads over reference rates (typically the London Interbank Offer Rate), we can decompose the costs of credit for firms. Fees have fallen in 2010Q4 according to the *Bank of England's Credit Conditions Survey* for both larger and medium sized firms, with greater declines for larger firms. Spreads on loans to large firms have narrowed, while spreads for medium sized firms have widened slightly. This presents a mixed picture for the cost of credit to medium sized firms, but an improvement in costs for larger firms.

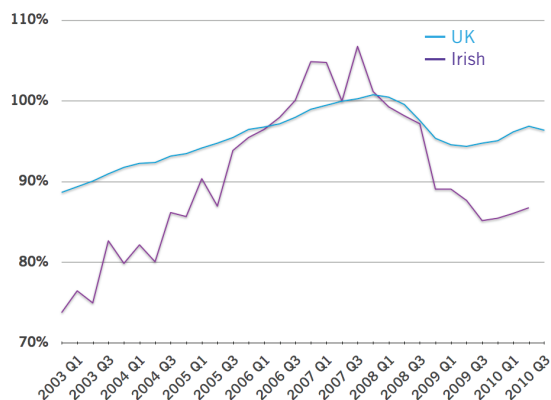
The underlying cost of funding to lenders based on the cost of wholesale funding fell in the first part of 2010Q4 but rose again in the second part. This will have affected costs, but lenders have diversified the sources of funding across retail (deposits) and wholesale sources, as well as different currencies, since 2007, to avoid a return to heavy reliance on short-dated wholesale funding typical of banks prior to the crisis.

CREDIT CONDITIONS, DEFAULT RATES AND INSOLVENCIES

Lenders have also reported improvements in the availability of credit to the corporate sector as a whole, larger maximum credit lines and improvements to covenants attached to loans by lenders. Default rates on loans have been steadily declining through 2010 for large and medium sized businesses. The UK Insolvency Service reports that insolvencies of firms in England and Wales declined by 11.3% on the same period a year ago. This suggests that firms are on a surer financial footing than they were previously.

CHART 6: UK and Irish GDP growth (market prices)

Source ONS & Irish CSO



ECONOMIC CONDITIONS IN THE UK AND IRELAND

REASONS WHY THE RECOVERY MIGHT BE 'CHOPPY'

- Volatility in commodity prices, especially oil
- The uncertain impact of government budget cuts and VAT on spending
- The inflation outlook and possible interest rate increases
- Wage costs and profitability concerns
- Variable external demand as Europe and China slow and US searches for growth
- The earthquake in Japan has added further uncertainty to demand and supply conditions.

ECONOMIC GROWTH AND DEMAND

UK economic growth fell by 0.6% in the year to 2010Q4 revised down from the previously estimated fall of 0.5%. This was partly due to the heavy snow in December, but growth was weaker than expected. Output of the production industries rose 0.7%, with manufacturing increasing by 1.1% while construction output fell by 2.5% and extraction industries fell by 4.5%. Service output fell 0.7%. GDP growth for the full year is now 1.5 percentage points higher than 2009Q4; but the level of GDP is still 3.6% below the level at the start of the financial crisis (see Chart 6).

The reason for weaker than expected growth in the UK can be seen in the spending figures. Growth in the spending by households declined by 0.1%, and investment fell by 2.5% in the quarter. In anticipation of budget cuts, increases in energy costs and VAT, as well as greater unemployment, spending is being reduced, and saving increased. Firms are investing less, and have built cash balances, which now stand at 4.3% of GDP. Government spending increased by 0.7%, which is 1.2% higher than 2009Q4, but it will decline sharply as government cuts are implemented from April.

The situation in Ireland is more severe, since GDP growth fell -0.5% over the year. The level of GDP is 13.2% below the level at the start of the financial crisis (see Chart 6).

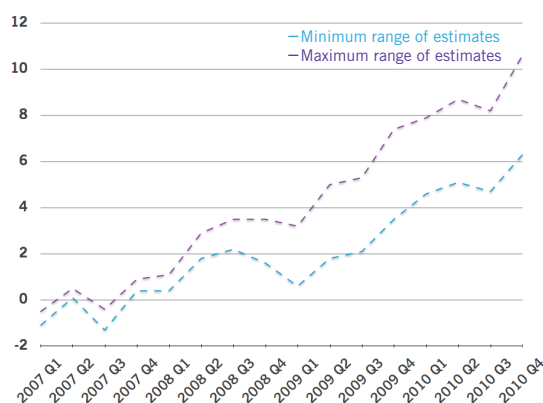
SALES, ORDERS AND CONFIDENCE

According to the *British Chambers of Commerce Survey*, the percentage balance of firms reporting an increase in sales versus those reporting decreases increased by 6 points to 23% and for orders it increased 6 points to 19%. Exports of manufacturers jumped by 13 points to 37%, and orders rose by 21 points to 39%. These are the strongest figures since 1994, and the second highest figures since records began in 1989. Confidence in manufacturing reached a three year high, at 48%, with services confidence up 12 points to 26%. Much of this reflects the stronger export position due to movement in the real effective exchange rate since 2008.

Sales in Ireland fell by 1.4% in the final quarter and by 4% over the year.

CHART 7: Bank of England's estimates of the impact of VAT, energy prices and import prices on the level of consumer prices

Source Bank of England



SPARE CAPACITY

The increase in sales and orders reduced spare capacity in manufacturing, but labour productivity is well below its pre-recession level, meaning that employees could increase output and raise capacity by working harder. The capacity of the whole economy also depends on the number of firms closing down compared to the number of new firms being formed. Data shows that there have been 32,424 new companies formed in 2010 up by 13.2%, and 16,044 liquidations, down 11.3%. Both figures are much lower than comparable figures in the previous recession.

INFLATION AND INTEREST RATES

Bank Rate remains at 0.5%, but inflation has now reached 4% - double the Bank of England's target level - and inflation is expected to increase further to 5% before falling back towards target in the summer of 2011. A large part of the increase in prices is due to commodity price increases, the VAT rise, and higher import prices. The impact of these effects on inflation is shown in Chart 7.

Commodity prices are not expected to remain high, but oil prices in particular are sensitive to events in the Middle East. VAT has a one-off effect on prices that will not continue to affect inflation. Import prices on the other hand will vary with the exchange rate, and this depends on the speed that UK interest rates are expected to rise, compared to rates in other countries.

The euro area has kept interest rates at 1%, but inflationary pressures are expected to lead to an increase in rates to 1.5% by the summer.