



SME Monitor

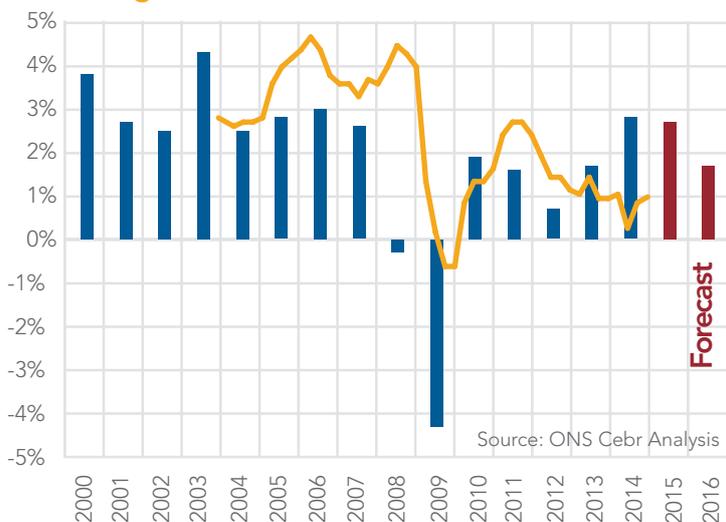
Q4 2014

The UK economy depends on the huge contribution that small and medium-sized businesses make in every region of the country. We must ensure that SMEs are supported and able to flourish. By taking a quarterly snapshot of how inflation is affecting their everyday operations, we are able to see the pressures that they face.

Executive Summary

- Annual cost inflation for UK SMEs remained stable at 0.9% in Q4 2014
- This is a small increase of 0.1% from Q3 but the rate remains low historically, and similar to Q4 2013
- Wage growth picked up in Q4, contributing nearly three quarters of the cost rise experienced by SMEs
- The cost of physical inputs continued to fall in Q4 2014, as has been the trend over the year
- Annual cost inflation of construction inputs grew strongly by 2.6% while telecoms & IT input costs fell by 3%

UK annual GDP growth vs Average SME annual cost inflation rate



In 2014, UK GDP growth was 2.8%, the strongest since 2006. GDP performance in 2015 is expected to remain robust at 2.7%

Small increase in cost inflation this quarter, but remains historically low

- Costs for the UK's small and medium-sized business population rose by 0.9% year-on-year in Q4 2014, a small increase from last quarter's 0.8%.
- The costs of employment and construction increased strongly year on year in Q4 2014. Together they make up over 40% of all SMEs' costs. Meanwhile, the cost of business services increased year-on-year by 0.9%.
- These cost increases have been offset by declining physical costs and telecoms & IT costs. Indeed, physical costs have consistently declined both quarter on quarter and year-on-year over 2014.
- SME cost inflation remains historically subdued and broadly in line with Q4 2013.

Wage growth strongly increases SME costs

- Together employment cost and construction costs were the driving forces of SME cost increases in Q4 2014.
- Annual wage growth picked up strongly at 2.1% in Q4 2014, picking up from 1.2% in the previous quarter as the labour market continues to strengthen. Construction cost inflation also remains relatively rapid, at 2.6% in Q4.
- Furthermore, the cost of physical inputs fell 1.5% year-on-year due to reductions in the price of food, chemicals, metals, and gas.

Small and medium firms remain more confident than larger firms

- Confidence among UK businesses, as measured by the ICAEW/Grant Thornton Business Confidence Monitor, has continued to cool after peaking in Q2 2014.
- The spread between very large firms and SMEs has increased in the last quarter due to the different challenges faced.
- Domestic issues are of greater concern to SMEs. These firms face an uncertain UK election but have been boosted by the strong growth in domestic consumer spending.
- Despite the fall in recent quarters business confidence remains historically high, but it is evident that domestic and global uncertainties are weighing on the business outlook.

Median borrowing interest rates for the UK's small enterprises have continued to fall after peaking in February 2012

- Median borrowing interest rates for the UK's small enterprises have continued to fall after peaking in February 2012.
- The rate currently stands at 4.4%, an interest rate not seen since January 2011. However, this remains elevated compared to pre-crisis levels
- Rates for small enterprises remain above those enjoyed by their medium-sized counterparts. Indeed, the spread between Small and Medium-sized Enterprises remains roughly constant at about 1.3 percentage points.

Company liquidations fall to 2008 levels

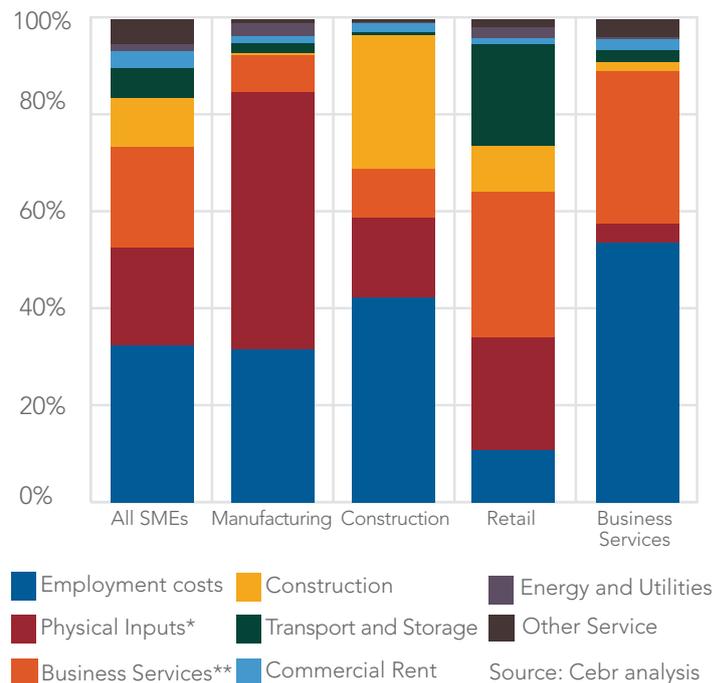
- The level of UK business failures continues to generally fall back year-on-year from its Q1 2012 peak.
- In Q4 2014, 3,735 companies when into liquidation, representing a slight uptick from Q3.
- However, failure levels are still higher than before the crisis, when they averaged 3,300 a quarter between 2004 and 2008.
- The downward trend is in part a result of the UK's highly accommodative monetary policy and strong consumer demand over the past year.
- When the Bank of England begins tightening monetary policy in earnest after such a prolonged period of loose policy this may pose a challenge to the UK's businesses and potentially raise the level of insolvencies.

- The UK has not seen a rise in the base interest rate since July 2007, indeed it has been static at 0.5% for exactly six years. Consensus expectations for the first increase in the base rate are for Q1 2016.

Employment costs and physical inputs make up the bulk of average SME costs

- Purchases of physical inputs and labour costs are the largest costs for SMEs, accounting for some 20% and 33% of total businesses expenses for the average SME.
- On top of this, a further 21% of total costs are spent on business services such as legal & accounting, advertising, IT & telecommunications.
- SMEs in manufacturing are heavily weighted toward physical inputs – more than 50% of total cost is on these intermediate goods.
- SMEs in retail have a strong transport and storage weighting in their cost profile.
- Meanwhile, over half of the costs for business services SMEs are on employment.

Breakdown of business costs, % of total, by SME type



* including finance, legal & accounting, IT & telecoms

** including raw materials such as those from agriculture, mining and forestry, as well as manufactured products such as steel, textiles, timber, chemicals and foodstuffs.

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Methodological note:

The figures presented within this report are calculated from a range of data provided by the Office for National Statistics (ONS), including the Services Producer Price Indices (SPPI), Producer Price Indices (PPI), Institute of Chartered Accountants in England and Wales (ICAEW) / Grant Thornton Business Confidence Monitor, Bank of England Trends in Lending report and the UK Insolvency Service