

BCRS Quarterly Lending Conditions Outlook

The final quarter of 2010 has been more challenging than predicted by some, and the recovery in the first quarter more fragile and muted than the market anticipated. Certainly, it does not appear that the UK will have a easy ride out of recession – the road will be long and hard with setbacks along the way, particularly for certain sectors. A severe external shock to the global economy at any point within the next twelve months could easily tip the UK back into recession.

One of the key themes of the last quarter has been unexpected and unpredictable events that have impacted on the economy, both nationally and globally.

Together Q4 2010 and Q1 2011 preliminary GDP figures for the UK indicated growth as effectively flat, mostly down to the construction industry being hit by the poor weather over Christmas and weak demand in the first three months of this year. Whilst growth generally has picked back up, it has left major cashflow issues for some construction firms – companies of all sizes in this sector have been folding, and the pace of insolvencies seems to be picking up.

The flooding in Australia proved a major hit to global capacity of iron ore and coking coal, both key raw materials in steel

production. Tata specifically blamed this loss of output when increasing the price of structural steel by 17%.

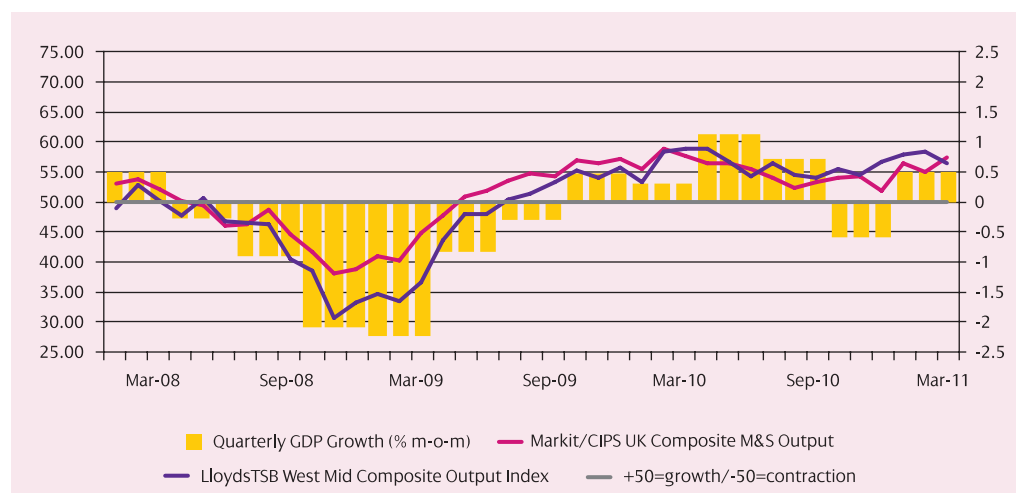
The uprisings in the Middle East and North Africa were also unexpected, and have led to a rise in the oil price. Whilst the economy looks to be weathering this at the moment, the big issue will come if significant unrest spreads to Saudi Arabia. This looks unlikely, but then so did civil war in Libya six months ago. Could the economy cope with an oil price of \$180-\$200 for any length of time?

The Japanese earthquake and tsunami will have an impact on trade – we are just starting to see the impact on global supply chains with scaling back of production at some UK car plants. This underlines how connected the UK is to the global economy. We cannot ignore what is happening overseas – it will have an impact on the UK economy.

Interest rates remain low and are likely to do so for some months to come. Wage inflation has been imported from fast growing economies in Asia, and added to by rising commodity prices (food/fuel/clothes) rather than the domestic wage-price spiral of the past.

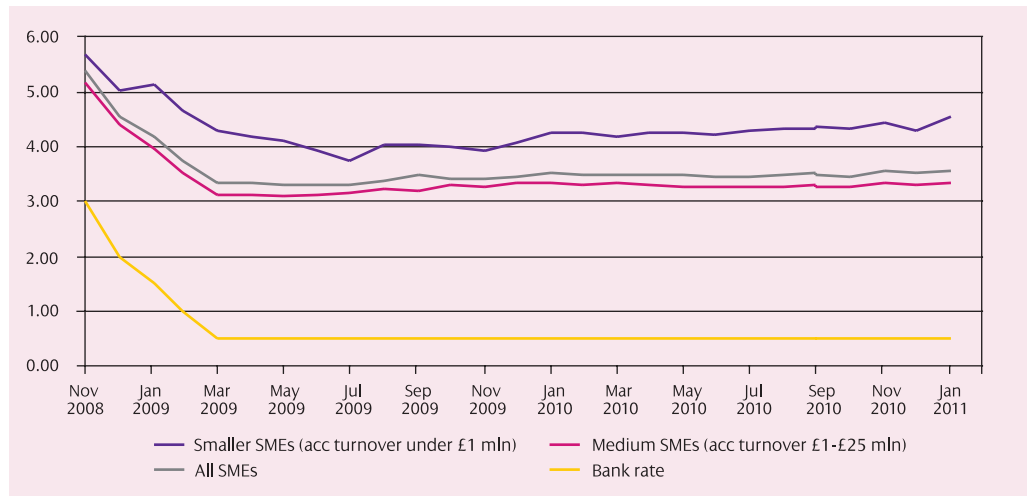
This means that the BoE will not raise interest rates quickly because of the impact on household expenditure. With consumer confidence already depressed, and most major retailers anticipating a long haul, the last thing that the government or BoE want to see is a wave of repossessions driven by increased mortgage costs.

West Midlands Output Performance



Source: ONS, Markit, LloydsTSB and Forrest Research

SME Indicative median Interest Rates (variable rate facilities)



Source: BoE

Cashflow continues to be an issue for many local firms. Though interest rates remain benign, rising input costs are depressing margins. This links back to the rises in commodity and oil prices. Though domestic wage costs are being restrained, input costs are driving price increases which is fuelling inflation.

The Budget in March contained some adjustments at the edges for businesses, such as the increase in R&D allowances, but overall was disappointing. Given the state of the public finances though, anything more imaginative was probably off the menu from the start.

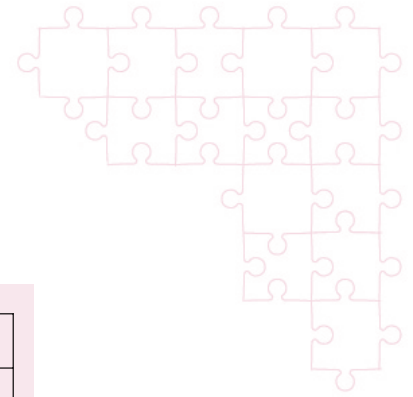
Working capital continues to feature as a major reason for companies to approach BCRS for loans. Recent surveys have highlighted that on average, most businesses are being paid by their customers at 20-30 days over term, with large companies being the worst offenders. Whilst this is a longstanding problem, the difference now is that companies have few resources left to cope.

As a result, the coming year will see more pre-packs and financial engineering as some of the issues that have been dragging on since 2009/10 come to a head. Cashflow problems will become the most immediate manifestation of this, and HMRC are likely to contribute significantly with their hardening stance on defaults and late payments, which is in part driven by downsizing within HMRC itself.

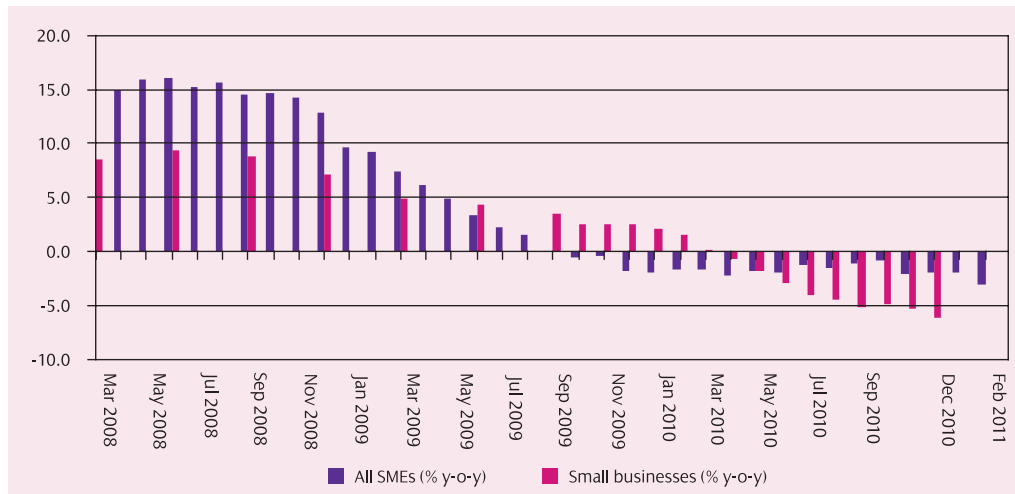
As per our previous Outlook, Bank lending will continue to contract in our key market – those SMEs turning over less than £2M per annum. Project Merlin will not impact significantly upon these smaller companies. Whilst the BoE has reported that larger companies are seeing some improvement in credit availability, smaller firms continue to struggle. Project Merlin was a missed opportunity in this respect, and should have insisted that banks decentralise all lending decisions to local level.

In terms of individual banks, LTSB seem to be able to accommodate credit for existing customers that they would be unwilling to do for new customers. Security policy seems to be flexible for existing customers and they appear to have reasonable in house sanctioning. Santander are making strong noises locally but we have had a couple of occasions where they have been let down by their central credit. All of the banks continue to have blanket restrictions on some sectors, even for good propositions.

Alternative forms of business lending continue to grow, and we are seeing more activity from non-bank lenders such as Business Loans Network and Funding Circle. These are aggregator operations that spread business loans amongst many private lenders. Finance Birmingham and Aston Reinvestment Trust also seem to be doing well for businesses based in Birmingham.



Lending to Small & Medium-sized Enterprises



Source: BoE

Construction

Some construction related businesses that we have come across seem to have full order books and be doing well. However, there are significant cashflow pressures within the industry that means even apparently profitable firms are going into administration. A recent Constructionline survey found that more than 90% of local authorities have concerns over the financial stability of their contractors.

With a number of mid-sized local construction firms failing recently, there is work to go around at a price, and we continue to see some firms taking work on at little or no margin. Negotiating the right payment terms and maintaining regular cashflow remain key to the health of

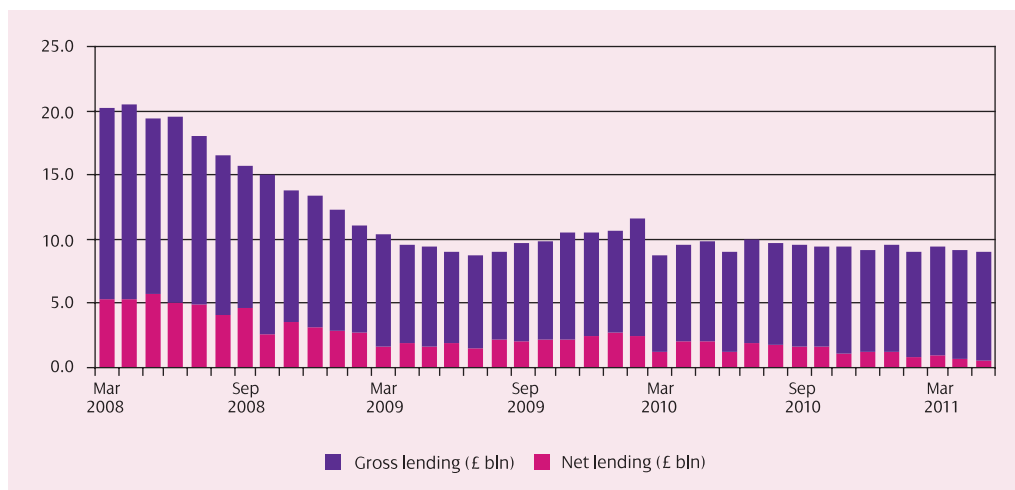
this sector. In the first quarter, output in construction fell by 4.7%. The deterioration of mortgage lending levels, both in net and gross terms, are likely to subdue the sector further over the course of this year.

Manufacturing

There is continued optimism in this sector. Order books are picking up and some work is coming back from China due to faster turnaround and lower production runs.

Exports seem to be leading the growth, particularly to Asia and the Far East. The German manufacturing sector is producing very high rates of growth at present, and this is one where the West Midlands has good links. Consumer demand from Asia is also driving growth in UK manufacturing.

Mortgage Lending by Major UK Lenders



Source: BoE.

Large manufacturers that are crucial to the local supply chain continue to see good news – GKN and Titan Europe have produced good quarterly results, and JLR have recently won £70m of investment. This should help local businesses.

Retail

The retail sector is in the firing line at the moment.

Depressed consumer confidence and squeezed household incomes means that many large retailers are suffering. Supermarkets in particular are also suffering from rapidly rising food prices.

Smaller local retailers will find conditions just as tough over the coming quarter, and will do all they can to preserve cash. This means that suppliers to retailers need to be very aware of invoices past term and the potential impact of sale or return agreements.

The retail sector will probably remain in the doldrums for at least another year. Any rise in interest rates will hit consumer sentiment. We are still likely to see one or two more big liquidations or voluntary arrangements, probably around quarter ends when rent payments fall due.

Public Sector

We are still waiting to see the full impact of the public sector cuts feed through. Although latest figures show that the number of private sector jobs being created have absorbed the number lost from the public sector, there is much more to come and the capacity of the private sector to take up the whole of the slack must be in doubt.

On the other hand, we would expect the rate of small company formation to increase over the next few months as many better-paid public sector workers look to establish their own businesses. The better ones will be those with well-thought out, innovative ideas who can sell to a particular niche in their market. However, we can expect a fair amount of 'me-too' businesses being set up, especially in consultancy.

Conclusion

Whilst the recovery will be long and slow, the coming two quarters will give us a clearer picture of exactly how much danger we are in of slipping back into recession. Public sector reorganisation, and the ongoing fallout of natural disasters and political turbulence will weigh heavily on the economy. Any further external shocks to the global and UK economy may tip us back into negative growth. We need a period of relative calm to allow hard work to pay off – let's hope we get it.

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