# Crisis, what crisis?

*A study of the impact of the financial markets crisis on the ‘real’ economy of Great Britain*

Siemens Financial Services, August 2008

## Management Summary


- A quarter (25.3%) of British firms have seen their cost of borrowing rise since the international financial markets crisis in 2007

- A further 15% of companies have been told by their bank that interest rate increases are on the way.  Around half (7%) of those receiving notices of credit cost increases have already experienced a rise, with the other half (8%) being notified of rises to come

- 16% expect their credit limits to be capped or revised downwards in the next six months

- The IT & Telecoms sector is hardest hit by the financial markets crisis, when viewed in terms of rising costs now combined with outlook for the rest of 2008

- A fifth of the IT & Telecoms sector is actively increasing use of asset finance to address the financial markets crisis , at 22.4% almost twice the national average of 13.4%

- Overall, compared to the national average, more large firms have seen credit cost rises, more medium sized firms have received notice of rises from their bank, and more small firms expect a combination of credit cost rises and credit limit caps in the second half of 2008

- On the other hand, some 20% of companies believe they will be largely unaffected by the financial market crisis, indicating a polarisation of British business in their exposure to the tightening credit climate

## Introduction

Anecdote, as reported in the UK media in recent months, would lead us to believe that the aftermath of last year's liquidity crisis in the international financial markets is having a catastrophic effect on the overall 'real' economy. The last few months have seen Marks & Spencer and John Lewis, belwether retailers, warn of drastically reduced consumer spending. European new car registrations have fallen sharply. Taylor Wimpey, the housebuilder, and Bradford & Bingley, the mortgage finance provider, have been seeking refinancing investment. The FTSE 100 share index has repeatedly teetered on the brink of a 20 per cent fall from its high last October[1].

There are plenty more indicators to be found. A study by the insurance company Axa found that three in four families with an income of more than £30,000 were planning to rein in spending this year as household budgets become increasingly stretched. Other analysts have estimated that 1.4m homeowners will need to remortgage over the next 12 months as fixed-rate and discounted deals are withdrawn from the market[2]. Prudential, the largest pension provider in the UK, has published a survey showing that that people were halving the amount they were putting into their pension plans. In its latest quarterly Economic Survey the British Chamber of Commerce claimed that UK firms' cashflow was at its worst position since comparable records began in 1992.[3] House prices fell for the eighth consecutive month during June, while annual growth fell at its fastest rate since the 1990s crash. According to the latest figures from the Bank of England (May 2008), the number of mortgages approved for house purchase fell to just 42,000 – the lowest monthly approval volume for the last fifteen years.

Yet the picture is by no means as clear as crystal. Retail sales data overall has remained somewhat buoyant. The Office for National Statistics (ONS) said retail sales volumes went up by 3.5 per cent in May, giving the lie to analysts' expectations of a month-on-month drop. In the latest quarterly figures, sales had risen 1.8 per cent on the previous quarter and 5.4 per cent since the same period a year earlier. The same organisation in its June labour market report demonstrated that British business is still, however, resilient. Employment continues to rise and unemployment fall with wage pressures remaining broadly under control.

Nevertheless, the recent and rapid deterioration of the UK economic situation brings into question whether this buoyancy can continue. Public sector borrowing in the first two months

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[1] Source: London Stock Exchange

[2] Source: MoneyFacts, who estimate that up to 90 mortgage deals per day are being withdrawn from the market (June 2008)

[3] The British Chamber of Commerce, Q2 Economic Report, 8 July 2008

of the financial year was 50 per cent higher than in 2007-08[4], with the shortfall caused by VAT and corporation tax receipts growing more slowly than the Chancellor had predicted and dramatic falls in areas such as Land Duty Stamp Tax not offset by growth in oil and fuel duties.

The corporate sector is showing very tangible signs of a downturn, although the falls are gradual rather than dramatic.  Price/equity ratios have fallen for the FTSE 100, from 13.6 times at the October market peak to about 10.4 times in June, although the change has been largely the result of share prices softening, rather than a fall in hard earnings. Business investment for the first quarter of 2008 was 1.8 per cent lower than the previous quarter but is estimated to be 4.5 per cent higher than the same period of last year.  By asset, the fall in private sector manufacturing investment was driven by lower capital expenditure in vehicles (down 6.7 per cent) and other capital equipment (down 4.7 per cent).  Looking at year-on-year trends, compared with the first quarter of 2007, total non-manufacturing investment rose by 5.4 per cent and total manufacturing investment fell 3.2 per cent.

## Pressures on corporate financing

In short, then, the difficulties experienced by national and international banks with investments in sub-prime mortgage-backed securities market last year are now definitely filtering through to the real economy in Britain.  However, in terms of business size and sector, there is little or no data to indicate who is coming under the greatest pressure, especially in terms of that most important of economic lubricants – availability and price of credit.  If companies large and small cannot access reasonably priced working capital, then this will exacerbate and accelerate an economic downturn, along with other factors, turning a tight economic period into a palpable recession.

In order to put some broad metrics on this key issue of credit availability in the UK marketplace, along with a research view of how firms are using alternative sources of finance in a credit squeeze, Siemens Financial Services commissioned a research study into the topic.  The study was based on original fieldwork, completed during June 2008, which interviewed a balanced sample of 736 British businesses.

A quarter of firms (25.3%) have experienced a rise in their borrowing costs since the credit crisis hit the international financial markets back in September 2007.  Around one sixth of companies (15%) have been told by their bank that cost increases are on the way, and one third expect their costs to rise over the next eighteen months.  Only 8.7% of companies have had their credit limits capped so far, but twice that number expect credit caps to come into force this year.

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[4] Source: Office of National Statistics

## Company Size Differences

Hardest hit by credit cost increases have been very large firms with over 2000 employees (28.2%). However, it may be an advantage to these larger companies that their credit cost increases have already taken place, in that they can now plan their business strategies on a more stable basis for the next 12-24 months. This is not to say that credit conditions, even for larger firms, will not tighten. Large firms seem not only to have already seen an increase in the cost of credit, but also expect further rises, both for their sector and for the whole business community.

In contrast, an above average percentage of medium-sized enterprises (200-1999 employees) have been notified by their bank to expect an increase in their borrowing rates over 2008-2009. Furthermore, the outlook amongst small firms (50-199 employees) is focused more on the expectation of borrowing rates rising and the possibility that their credit limits will be capped – a credit squeeze.

Medium-sized companies are the most energetic in seeking alternative financing tools outside of straight relationship borrowing, with almost one in five actively doing so. One seventh (13.4%) of the business community is focusing on asset finance as a key financing tool, small firms being the most active in this area (14.2%).

The importance of alternative financing tools, such as leasing and asset finance, is paramount in an economic climate that is tightening, and where credit availability and terms are being squeezed. According to a recent research report from Siemens Financial Services, almost £35bn lies frozen in outright equipment purchases which could be far more efficiently deployed through the spread payments which are typical of asset finance. Converting equipment purchases to a financing plan can therefore free up very considerable volumes of working capital, a critical financial facility when other forms of credit are becoming less available and more expensive.

## Sector Breakdown

Interesting, fully one fifth of businesses feel that the credit crunch will have no, or marginal effect on their business. A glance at sector differences reveals that the Leisure, Holidays and Catering sector, along with the Chemical Industry are particularly unconcerned about the credit crunch, whereas the Construction Industry is exceedingly despondent about the depth of its effect.

Looking further into sector differences, IT & Telecoms (29.6%), Manufacturing (27.3%), and the Financial Services industry itself (31%) have been most affected by a rise in the cost of credit. The reasons for particular exposure in these sectors probably varies. The Financial Services industry has, obviously, had to write down its losses from the crisis. Manufacturing has high requirement for capital investment compared with other sectors, and therefore presents a more delicate risk profile for lenders in times of economic pressure. And IT & Telecoms investments – especially upgrades – are often delayed when revenues and margins fall, especially if the prime sufferer in an economic downturn is an industry well known for its high levels of IT investment - namely the Financial Services Sector. However, in terms of the combined current and future outlook, it is the IT and Telecoms sector that appears to be particularly hard hit by the credit crunch. Compared with the all-sector average, more IT and Telecoms have seen credit costs rise, expect them to rise further, have been contacted by their bank to expect rises, and have seen their credit limits capped.

Regarding the surprising data from ONS on retail spending buoyancy in the first half of 2008, this survey reveals corroborative evidence that the Retail sector has experienced less of a rise in credit costs than other industries. However, the Retail industries also have a particularly gloomy outlook on this issue for the second half of 2008, indicating a feeling within the sector that this buoyancy will not last to the end of the year.

Service businesses in the Media, Marketing & Consultancy industries have not so much seen their cost of credit rise as have their credit limits capped. Their outlook on the second half of the year, however, is almost as gloomy as the Retail sector, with 44% of firms expecting credit cost increases.

## Regional Variations

The impact of the credit crisis on British business also shows some stark regional variations. Rises in the cost of credit have been felt most keenly in Greater London (33%) and Scotland (30%), whereas bank notifications of an impending rise in interest charges are being experienced by the greatest proportion of firms in London and the Midlands. Expectations of a forthcoming rise in credit costs in the respondent’s own sector over the remainder of 2008 are gloomiest in Yorkshire (43%), Wales (41%) and Greater London (41%). In terms of expected credit cost increases across the whole economy, the outlook is bleakest in the North East (61%) and – again – Wales (59%). A downturn in credit limits has been most prevalent in Inner London (20%), with the outlook for downward credit limit revisions for the rest of the year being least optimistic in Yorkshire (25%) and Scotland (24%).

In the drive to find new means of managing working capital in the current credit squeeze, the highest proportion of firms exploring alternative financing tools occurs in the West Midlands (27%) and the South West (23%). However, when it comes specifically to an expected increase in the use of asset finance, the South West (18%) and Inner London (18%) come top.

In a final qualifying question, which sought to understand what proportion of firms felt they would be unaffected by the credit crisis, most sanguine were Yorkshire (29%), East Anglia (27%) and Scotland (30%), all well ahead of the national average of 22%. This last finding is particularly interesting, in that it indicates a polarising business population, a quarter of whom are experiencing their cost of credit rising, but a further fifth who consider they will be virtually unaffected by the credit squeeze.

## Conclusion

This survey clearly shows that last year's crisis in the international financial markets is filtering through to the real economy in the UK. Large firms have already seen the price of relationship credit rise, medium-sized firms are experiencing a cap on their credit limits, and smaller firms expect both these phenomena to affect them in the second half of the year. The reason for large firms to be more immediately affected is probably due in large part to the fact that the rates of interest charged by their relationship banks are individually calculated, with a great degree of risk assessment precision. In contrast, medium-sized and smaller firms interest rates tend to be less finely assessed, with interest rate bands being periodically adjusted on a mass level, usually with a certain time-lag following the economic and financial causes behind those adjustments.

The majority of respected commentators believe the economy will still grow between 1-1.5% this year, but are equally of the view that a technical recession is still a distinct possibility. If the British business community is to avoid a prolonged recession then UK plc's cash flow, supported by access to liquidity at a realistic and reasonable cost, has to be maintained. This report shows signs of deterioration and expectations of further tightening. Other recent reports indicate the potential for a mild recession to become acute.

Recent years have seen very easy access to credit at very low cost. Spreads have been extremely narrow, and a large element of rate-for-risk decision making absent. Now times have changed radically, and rapidly, emphasizing that cash is a scare resource, and that consistently successful business are those that treat cash as a scare resource even when it seems all too easily available.

For those business that have extended their credit lines to the $n^{th}$ degree, there is no silver bullet. However, for the far larger number of businesses simply fighting to remain cash flow positive or to access re-investment capital, seeking alternative sources of credit is a simple first step. One in seven of the sample questioned in this survey have turned to leasing and asset finance to free up working capital this year. More dynamic activity is required from corporates in the search for alternative financing, along with greater efforts by the financial services industry to make additional forms of affordable financing available, if the country is to successfully ride out the current storm.

# The Data

(*Sample base: 736 companies, broadly representative of firms with 50+ employees*)

| % Agreeing with the Statement | TOTAL | Manufactuing & Hi-tech Engineering | Construction & Property | Financial Services | Media, Marketing & Consultancy | Hospitality & Catering | Transport & Communications | IT & Telecoms | Retail & Wholesale | Chemicals & Pharmaceuticals |
|---|---|---|---|---|---|---|---|---|---|---|
| My firm's cost of borrowing has risen since the credit crisis first hit the financial markets last year | 25.3% | 27.3% | 15.8% | 31.0% | 16.0% | 25.0% | 22.7% | 29.6% | 20.3% | 8.3% |
| My firm's bank(s) has been in touch to indicate that cost of credit may rise in 2008/2009 | 15.0% | 11.4% | 0.0% | 13.8% | 0.0% | 2.8% | 9.1% | 27.8% | 8.5% | 16.7% |
| I expect the cost of credit for companies in my sector to rise in 2008 | 33.0% | 31.8% | 36.8% | 37.9% | 44.0% | 19.4% | 31.8% | 38.9% | 44.1% | 25.0% |
| I expect the cost of credit for UK companies as a whole to rise in 2008 | 38.3% | 38.6% | 63.2% | 51.7% | 48.0% | 30.6% | 44.3% | 44.4% | 40.7% | 25.0% |
| My firm's bank has adjusted one or some of our credit limit(s) downward since the credit crisis first hit the financial markets | 8.7% | 4.5% | 0.0% | 5.2% | 24.0% | 2.8% | 11.4% | 18.5% | 10.2% | 8.3% |
| I expect credit limits for companies in my sector to be capped or revised downwards in 2008 | 16.0% | 15.9% | 15.8% | 17.2% | 20.0% | 11.1% | 15.9% | 16.7% | 20.3% | 8.3% |
| My company, and companies like ours, are actively exploring alternative financing tools (other than straight lines of credit | 17.6% | 13.6% | 26.3% | 24.1% | 8.0% | 22.2% | 18.2% | 14.8% | 16.9% | 8.3% |
| I expect my company's use of asset finance (acquiring new equipment and/or plant through a finance plan) to increase in 2008 | 13.4% | 13.6% | 5.3% | 12.1% | 8.0% | 5.6% | 8.0% | 22.2% | 18.6% | 8.3% |
| The impact that the credit crunch will have on my business is of great concern, but I am unsure as to its precise form | 26.3% | 36.4% | 31.6% | 32.8% | 36.0% | 22.2% | 25.0% | 25.9% | 35.6% | 25.0% |
| No effect, or marginal effect on my business | 22.5% | 15.9% | 5.3% | 19.0% | 12.0% | 36.1% | 22.7% | 14.8% | 16.9% | 50.0% |

| % Agreeing with Statement | TOTAL | 50-199 | 200-1999 | 2000+ |
|---|---|---|---|---|
| My firm's cost of borrowing has risen since the credit crisis first hit the financial markets last year | 25.3% | 22.8% | 24.0% | 28.2% |
| My firm's bank(s) has been in touch to indicate that cost of credit may rise in 2008/2009 | 15.0% | 15.7% | 17.9% | 11.8% |
| I expect the cost of credit for companies in my sector to rise in 2008 | 33.0% | 38.1% | 26.7% | 35.4% |
| I expect the cost of credit for UK companies as a whole to rise in 2008 | 38.3% | 40.6% | 34.0% | 40.7% |
| My firm's bank has adjusted one or some of our credit limit(s) downward since the credit crisis first hit the financial | 8.7% | 7.6% | 10.7% | 7.5% |
| I expect credit limits for companies in my sector to be capped or revised downwards in 2008 | 16.0% | 17.3% | 16.0% | 15.0% |
| My company, and companies like ours, are actively exploring alternative financing tools (other than straight lines of credit) | 17.6% | 14.7% | 19.8% | 17.5% |
| I expect my company's use of asset finance (acquiring new equipment and/or plant through a finance plan) to increase in 2008 | 13.4% | 14.2% | 12.2% | 13.9% |
| The impact that the credit crunch will have on my business is of great concern, but I am unsure as to its precise form | 26.3% | 23.9% | 24.4% | 29.6% |
| No effect, or marginal effect on my business | 22.5% | 23.9% | 19.8% | 23.9% |

## Methodology

739 UK companies participated in an online survey during the period ending June 2008. Respondents, all senior decision makers, were asked about the impact of the credit crunch on their firms, their industry and the British economy as a whole. Fieldwork was conducted by Ciao Surveys, part of the Greenfield Online Group (NASDAQ: SRVY)