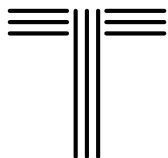


THINCATS

PRISM INSIGHTS

# AN ANALYSIS OF UK MID-SIZED SMES: WHERE NEXT FOR INSOLVENCY RATES?

Historically low insolvency rates in 2020 point to the success of government business support schemes during the Covid pandemic. But, with signs of stress already visible in some sectors, is a spike in future insolvencies inevitable and what are the early warning signs that we should be looking out for?

## Insolvency rates in mid-sized SMEs: are government measures just buying time?

Headline figures for the full year 2020 show insolvency rates for mid-sized SMEs at historically low levels but looking beneath the surface reveals a more nuanced story. Some segments – notably larger firms in sectors reliant on footfall – are already starting to diverge from the pack with insolvency rates more than twice the national average, having doubled from 2019 to 2020 when the rest of the population saw a reduction.

More than a year on since the start of the Covid pandemic, debt as a percentage of the UK economy has reached levels last seen in the early 1960s while GDP growth has recorded its largest yearly fall on record, at 9.9% in 2020. Despite these grim statistics, the current low insolvency figures come as no surprise given the raft of government-issued company lifelines, along with all-time low interest rates. But are these schemes simply delaying the inevitable or will there ultimately be fewer companies going to the wall as a result? This report evaluates the data so far and compares it to that of the last recession in 2008/9..

**PRISM** is our proprietary credit risk model specifically for mid-sized SMEs. It is a powerful data analytics tool that we have trained on the core universe of more than 750,000 mid-sized firms, using financial information from over 7.1 million filed accounts over a full economic cycle (2007-2019).

The model has been extensively tested to predict accurately and consistently across different industry sectors, sizes of business and geographies.

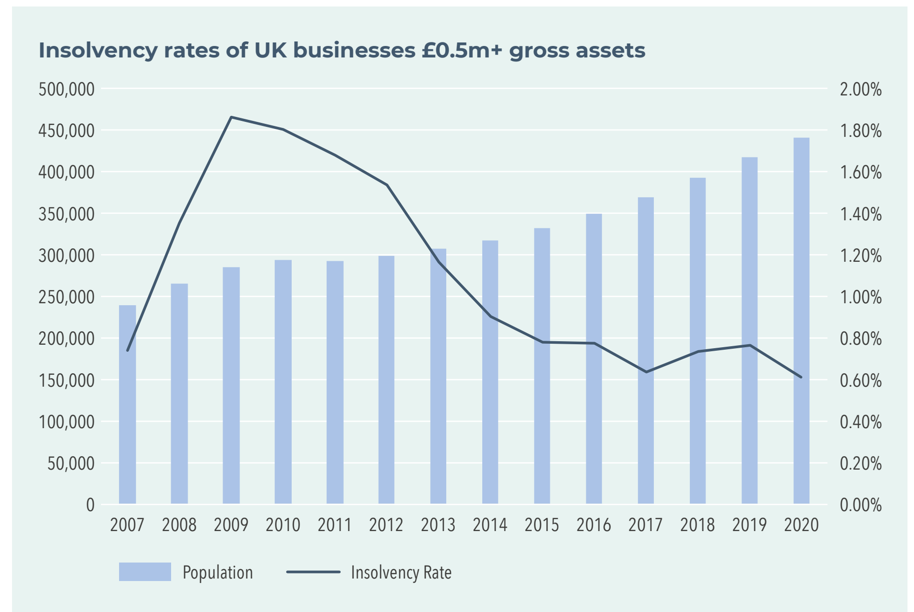
We believe it provides unrivalled insight into the UK's universe of mid-sized SMEs enabling us to assess our lending appetite – and at what price – and manage the assets for our institutional funders in line with their investment objectives.

## Insolvency at historic lows

At first glance, the financial health of the mid-sized population looks relatively good. The official insolvency rate for companies with £0.5m+ in gross assets was 0.61% for the full year in 2020. This compares with a peak of 1.86% during the Global Financial Crisis (GFC) in 2009 and is, in fact, lower than both the pre-crisis level of 0.81% in 2007 and the pre-Covid level of 0.76% in 2019.

INSOLVENCY RATE FOR COMPANIES WITH £0.5M+ GROSS ASSETS WAS 0.61% FOR 2020

This suggests that the £280 billion of government support put aside to help businesses through the pandemic has prevented – or at least deferred – insolvency for the majority of firms in this size bracket. The chart below shows the insolvency rate for these companies, which represented around 250,000 firms in 2007 and 450,000 in 2020. It incorporates all liquidations, receiverships, administrations and voluntary arrangements for this population.



## But insolvency payouts at a ten-year high

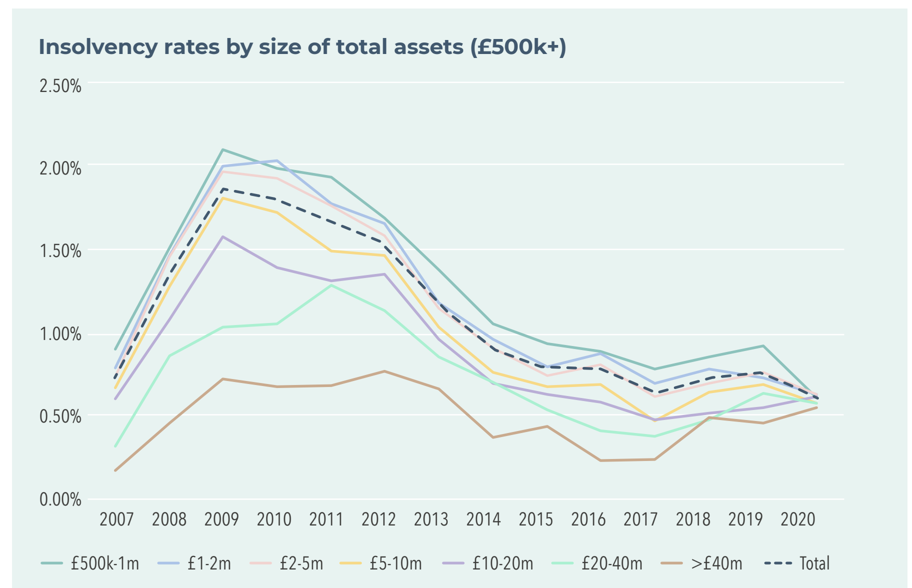
Although the overall insolvency rate fell, separate data shows that the Insolvency Service paid out more than £453 million in missing wages and benefits to workers at firms that went bankrupt last year. The money, which comes from the National Insurance Fund, is only distributed to former members of staff when their employer enters into corporate insolvency and yet the amount paid in 2020 was the highest it has been in the past decade, an increase of 31% year-on-year. How can we explain this discrepancy? The logical explanation is that it is the larger businesses – with more headcount - that are suffering higher insolvency rates while the smaller companies are surviving.

COMPANIES WITH £10M+ GROSS ASSETS SAW AN INCREASE IN INSOLVENCY RATES FOR 2020

## Are larger companies more likely to fail?

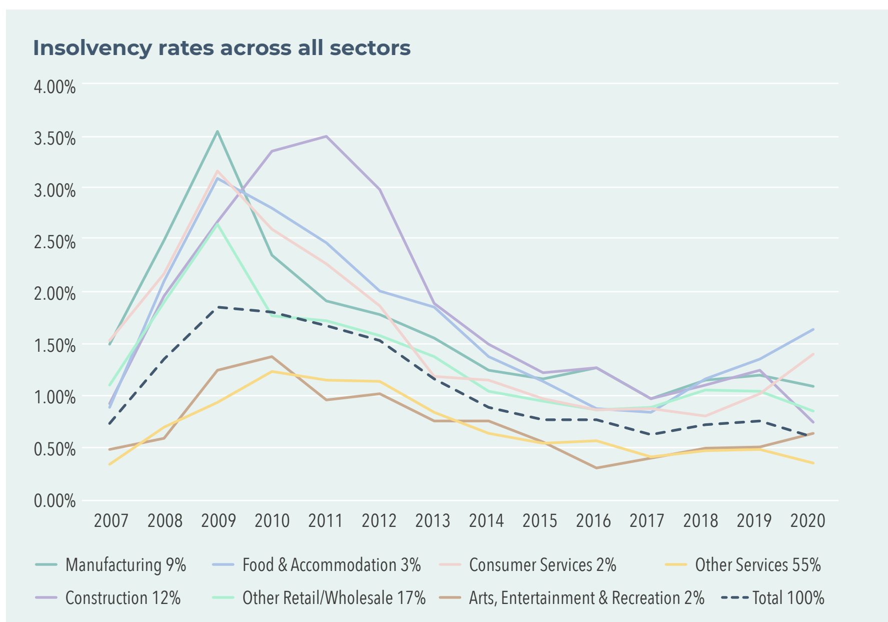
In more 'normal' conditions larger companies are generally less likely to fail than their smaller counterparts but our data confirms that this does not hold true in the wake of the pandemic. Companies at the larger end of the mid-sized population, with £10 million or more in gross assets, saw an increase in insolvency rates in 2020 while the remainder trended downwards in line with the overall rate.

## Size is a discriminator



## Which sectors have been impacted?

At sector level, the picture is relatively uniform, with almost all sectors enjoying a downward trend in insolvency rates in 2020. But there are three sectors that stand out – 'Consumer Services' (including hairdressers, travel agents and repair shops), 'Food & Accommodation' and 'Arts, Entertainment and Recreation' – which collectively represent around 7% of the mid-market population, are all on an upward insolvency trajectory.




It is worth noting that these sectors were already seeing rising insolvency rates prior to 2020, reflecting perhaps the well-documented "demise of the high street", a fall in discretionary spending and excess supply versus demand in these areas.

## Footfall exposure is a key discriminator

The three sectors that are bucking the trend of lower insolvency rates can broadly be classed as footfall sectors, i.e. businesses that are reliant on customers physically visiting their premises to generate income. Those dependent on higher footfall have inevitably suffered due to three lockdowns in the UK because buyers simply could not come through their doors.

On average, these were also the sectors that were less financially robust before the pandemic struck, due to long-term challenges with discretionary spend, low margins and overcapacity. For these areas of the economy cashflow is even more vital so the combination of forced closure and lack of capital reserves has afforded them no time to adapt and restructure.

Most other sectors have been able to continue trading to some extent. A lot of retailers and manufacturers had an existing online presence, or have been able to migrate online while service industries, such as financial, insurance and real estate, have been able to operate with staff working from home. These businesses are also less exposed to discretionary spend so they have been less immediately impacted.

These findings intuitively make sense but when you combine footfall exposure and size of company the data is even more revealing.

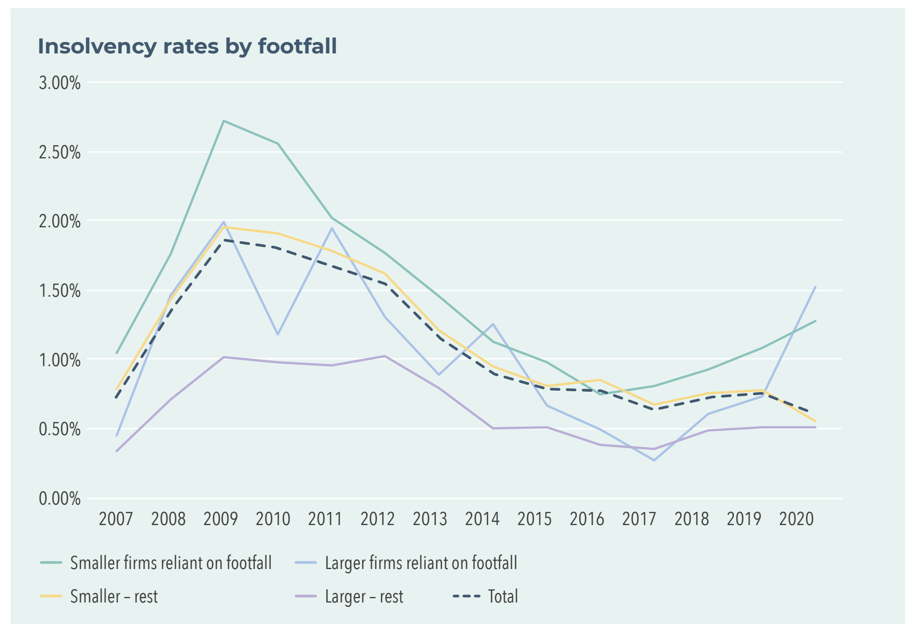
## Large businesses reliant on footfall hit hardest

Splitting the mid-sized population into larger enterprises (£10 million total assets or more) and those with sub-£10m of assets, and simultaneously into footfall and non-footfall sectors reveals an even clearer divergence.

Although large businesses reliant on high footfall make up only a small population in numerical terms, these businesses experienced the sharpest rise in insolvency rates in 2020. Admittedly, the insolvency rate for this segment was already on an upward trajectory starting in 2017, but it doubled from 0.76% in 2019 to 1.52% in 2020 – a significant steepening of that trajectory

In contrast, smaller businesses reliant on high footfall have remained on a more gradual path of rising insolvencies stretching back to 2016 with insolvency rates increasing by 20% in 2020. This rise is more likely to represent a continuation of the retail trend we have seen since the emergence of online shopping - of small independent retailers struggling on the high street - than a sign of Covid-related stress. Many of these smaller companies may actually have seen some positive impact from the pandemic as people stayed closer to home and chose to support small and local businesses.

RISING INSOLVENCIES ARE MORE LIKELY A CONTINUATION OF THE RETAIL TREND SINCE THE EMERGENCE OF ONLINE SHOPPING

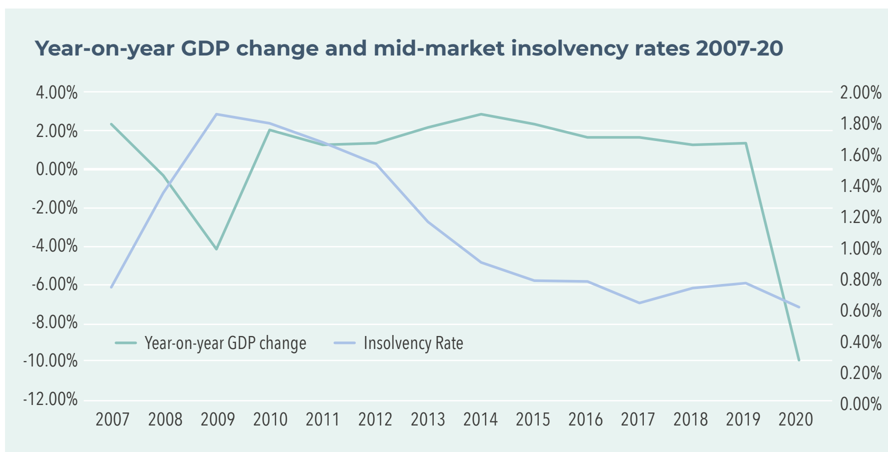


## How does this recession compare to the Global Financial Crisis?

During the GFC of 2008/9, insolvency was a leading indicator of the recession with insolvency rates for mid-sized SMEs already rising sharply through 2008 while the recession officially began at the end of that year.

This time, the UK has already suffered a recession – falling 3% in the first quarter of 2020 and 19% in the second quarter during the first lockdown – at a time when overall insolvency rates have gone down to a recent historical low of just over 0.6%. The difference is the scale of government intervention, which has bought many businesses vital time to be able to continue trading when regulations permit and/or to reshape their business model.

Furthermore, the impact of the 2008/9 economic shock was largely sector agnostic, with all industries suffering a similar rise in insolvency and a similar pattern of recovery in the months after the crisis. Whereas – as outlined above – the "Covid shock" has already seen some sectors' insolvency rates rise while other sectors have, so far, been less impacted.




WHERE WILL INSOLVENCY RATES GO NEXT?

There is no doubt that without government support there would have been hundreds of additional mid-sized firms going bankrupt last year. If insolvency levels had continued at their 2019 rate into 2020 we would have expected an extra 674 mid-market businesses to have failed (i.e. 25% more) than were actually recorded in 2020.

Measures such as the furlough scheme, government grants, VAT deferrals and government-backed loan schemes such as the Bounce Back Loan Scheme (BBLS) and the Coronovirus Business Interruption Loan Scheme (CBILS) have certainly helped avoid the worst-case scenario.

One question that remains unanswered is how many of these "saved" businesses (that in 'normal' times would have gone to the wall) will now be able to continue for the long term. A bigger question, however, is how effective government support has been in preventing long-term scarring to the 95%+ of businesses that we would expect to continue trading after a typical recession. Will these businesses have sufficient financial resilience to shake off the pandemic and deliver the growth required to replace the economic contribution of other sectors that may take much longer to recover?

By digging into the 2020 insolvency data we can see that mid-sized businesses reliant on high footfall – especially those with assets greater than £10 million – are already feeling the stress despite the unprecedented levels of government support. Will other sectors follow as government support is pared back?

## What should we look for?

As the Coronavirus job retention furlough scheme comes to an end on 30 September, businesses will have to make difficult decisions as to whether to bring staff back on the payroll – and therefore take on additional costs – or lay them off and suffer the resultant impact on output. We may see early signals from June as businesses will need to contribute 10% towards the hours their staff do not work in July increasing to 20% in August and September.

Similarly, businesses that have benefited from BBLS and CBILS loans will have to begin making repayments after a year of payment holidays. There will be many businesses that have used these loans to survive but are in no way up to full speed and so we may see more driven into insolvency as these measures fall away.

There will also be those that have several months of rent arrears backed up and there will come a point where landlords can no longer provide those payment holidays and businesses will start having to pay.

It will also be interesting to note whether the vaccine rollout programme can lead to a sufficient bounce in economic activity for sectors like hospitality and leisure so that those that have survived so far can remain viable in the new post-COVID normal.

OUR PROPRIETARY CREDIT MODEL, PRISM, CURRENTLY CONTAINS ABOUT TWO BILLION DATA POINTS ON MID-SIZED SMES

Our proprietary credit model, PRISM, currently contains about two billion data points on mid-sized SMEs, including 14 years of monthly data from Experian on all UK companies in the £0.5 - £40m assets range. We will soon have financial accounts data from businesses impacted by the early months of COVID. The key determinant of survival will be the extent to which businesses can mitigate these impacts.

As this data emerges, we will be looking for signs of financial stress, such as increased gearing levels as businesses take on more debt, or significantly reduced profit margins where businesses have struggled to keep costs in line with income. This information will provide indications of which segments of the market are most likely to suffer as government support ends and which are well-placed to thrive as we enter the post-Covid era.

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