Federation of Small Businesses
The UK's Leading Business Organisation

FSB Voice of Small Business Index

Quarter 4, 2011

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John Walker, FSB National Chairman

2011 was a difficult year for the nation's small businesses. Owners and managers of small firms were hit by high inflation – although this is predicted to fall in 2012 – which constrained consumer spending power, leading to rising commodity prices; by paralysis hitting mainland Europe with the ongoing single-currency crisis; and by the UK economy starting to see unacceptably high, and long-term, levels of unemployment. Confidence among small businesses, as measured by the FSB Small Business Index (SBI), has been on a downward trend since Q1 2011 and this trend shows no sign of changing. The FSB Small Business Index has proved a good gauge for GDP growth in the past and seems to point to either no or mildly negative growth.

The final quarter of 2011 is as always dominated by the festive rush for Christmas presents, and those retail outlets that survive and those which disappear from the high streets. However, this period is crucial for all firms and, from the findings of the FSB 'Voice of Small Business' Index, weak trading across the board is a cause for concern. Not only has the main confidence tracker continued its downward trend, but the balance of small businesses that reported falling revenues rose to the highest level since the first half of 2010. With more than 75% also reporting rising costs, margins are being squeezed, with the consequences obvious to all.

A net balance of -4.6% of small businesses reduced their workforce in the three months to December 2011, which, while slightly better than expected, provides further confirmation of weak demand for labour. Government efforts to promote job creation among small businesses are welcome but, against a backdrop of low confidence, falling revenues and rising costs, we fear firms' hiring intentions will remain weak at least in the short term. Further negative news comes from the survey's findings that FSB members expect that revenues will slide to the lowest levels since the start of the report. Data from Q4 2011 shows that a net balance of -6.5% saw revenues fall, the worst since the same period a year before.

A concern for Government will be the level of small businesses operating below capacity. Just over 56% of small businesses reported that they are running below capacity, which points towards job losses and a reduction in business investment, such as in plant machinery. Much hope has been placed on business investment and this will appear as a negative sign to many observers and forecasters. The FSB is concerned that many small businesses may be downsizing temporarily or, even worse, permanently, owing to the worsening economic conditions. Once capacity has been lost in a small business it is very difficult to regain.

Given the challenges faced by small firms, as highlighted by this latest survey, the Government needs to do all it can to restore confidence and create the right environment for businesses to flourish. Last year's Growth Reviews contained many good policy ideas, which the FSB supported. The Chancellor's Autumn Statement put forward welcome measures to encourage bank lending to small businesses and boost investment through the seed enterprise investment scheme. Proposed reforms to the planning system and government procurement contracts to increase small firms' access were steps in the right direction too. However, many of these measures will take time to feed in. With the economic outlook remaining weak, the key now is to implement the reforms already announced. Putting in place tangible, permanent changes in the business environment will give firms the confidence to take on new workers, invest and make the most of the growth opportunities when they come.

We have received very positive feedback on the FSB 'Voice of Small Business' quarterly report from both Government and private sector forecasters and as such, we will be expanding the scope of small business reporting. The FSB with our partners at cebr will start looking at elements of the business environment such as exporting, finance and business investment. The first of these reports will be published for Q1 2012 in March 2012.

Economist's View

Charles Davis, Managing Economist, cebr

The final 'Voice of Small Business' Index of 2011 reveals a deeply pessimistic view of economic prospects. Most indicators have reached the lowest level since the inception of the survey in 2010 and the forward-looking parts point to a further deterioration in general business prospects as well as in revenue, spare capacity and employment. Meanwhile, inflation has squeezed margins at the same time that sales have decreased. Overall, responses show that many small businesses are under real pressure.

Business-focused services, including finance, are the only part of the economy that expects to see their business improve over the coming three months. Firms that compete for consumer spending are having a difficult time as consumers prioritise essential spending and precautionary saving. Costs are still on the up, with a majority of firms reporting rising outlays. Fuel and utility costs are cited as the most common factors, a sobering thought considering that the oil price refuses to come down despite a global deceleration of economic activity.

From a regional perspective, the East of England is the best performer in this quarter's survey, leaving behind areas such as the South East, the Midlands and London. Still, its score is well into negative territory and it is more of a one-eyed king among the blind than a bastion of strength. London has dropped far down the ranks, showing that even the capital is not immune to the country's economic climate even if house prices are still rising. If the eurozone crisis escalates, more job losses in finance are likely, which would have a disproportionate effect on London's economy.

The labour market, which was hit by a surge in public-sector redundancies, the speed and extent of which surprised everyone including the Office for Budget Responsibility (OBR), is expected to deteriorate even further. In line with this trend, more small businesses plan to cut staff than at any other point in the last two years as revenues fall and productive resources lie idle. This suggests that business investment may be low on a national level. At the same time, the other components of domestic demand – public spending, consumer spending and net exports – appear similarly muted. Altogether this means that the UK is probably due for low growth for an extended period.

In sum, the message small businesses are broadcasting in the survey makes for gloomy reading. Government cutbacks, Quantative Easing (QE) running out of steam and waves of crisis splashing across the English Channel are part of the reason for weak domestic demand. As a bright spot in the near future, a significant fall in inflation is expected to ease the pressure on consumers and give more room for discretionary spending, easing the strain on the hardest-hit sectors. A fall in oil prices would be a welcome addition to this trend, relieving not just private purses but also the finances of small firms. As previously predicted, business conditions still seem to be getting worse before they improve again.

UK macroeconomic update

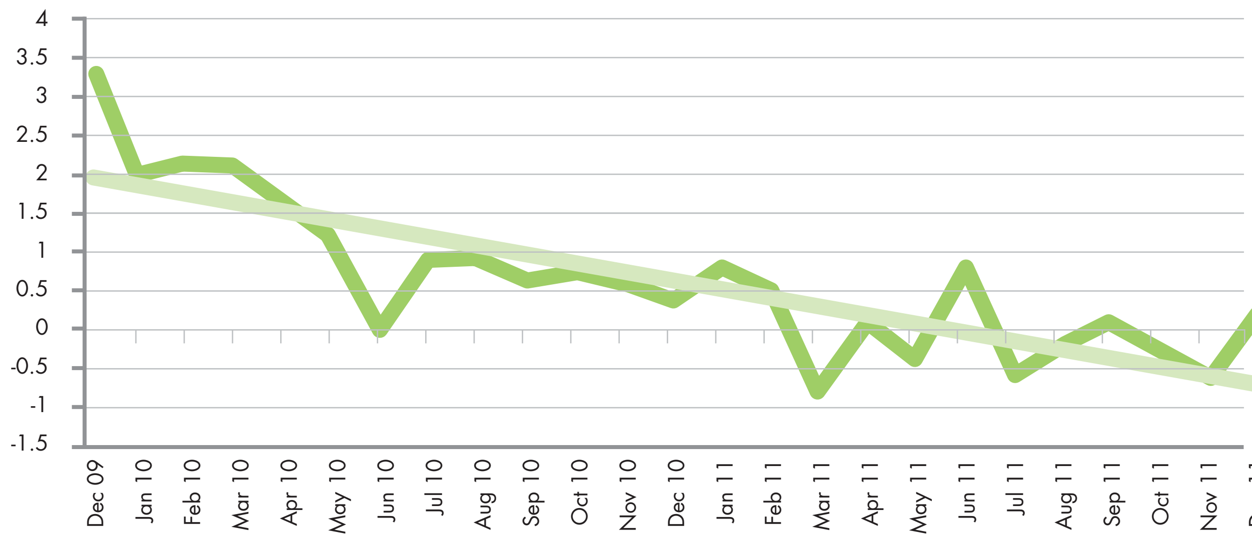
Low-growth outlook has become conventional wisdom

After the financial crisis, most growth projections assumed a medium-term return to economic growth of around 3% per annum. Most economists have now come to the realisation that an ongoing process of both public and private sector deleveraging has lowered trend growth for some time – much as an increase in leverage boosted growth prior to the financial crisis. The OBR revised its growth outlook down for the UK economy in its November update on the official projections and now forecasts growth of only 0.7% in 2012, moving in line with the long-standing cebr view.

One of the major areas of revision in the OBR forecast has been the extent of job losses in the public sector. This has contributed significantly to an increase in the unemployment rate, which could climb gradually to reach 8.7% by the end of the year, according to the OBR, although this may well be an underestimate. With inflation above 4% for the whole of 2011, consumers have cut back on spending. This is illustrated by Figure 1, which shows the downward trend in retail sales over the past two years. Heavy discounting supported sales somewhat in December, but the small increase has to be seen in the context of exceptionally weak sales last year due to severe winter weather. Retailers are likely to face a difficult 2012 even if inflation abates, as consumers are likely to remain frugal as they enjoy limited wage increases and continue with deleveraging.

The downside risks to the UK economy from adverse developments abroad weigh more heavily than the chance of an unexpected bump in growth. Although reform has begun, many of the fundamental drivers of the eurozone sovereign debt crisis remain in place. A wall of maturing bonds that has to be refinanced across the continent this year should soon put yields in the headlines again as several EU economies slide into recession. A soft landing of growth in China and the recovering strength of the US economy would provide some relief to the world economy, but external demand is likely to be weak overall, with the International Monetary Fund revising down its estimate of global growth for this year. In this context, small businesses will have to adapt to a low-growth environment and make the most of the available opportunities.

Figure 1: *UK retail sales, like for like, annual percentage change, three-month moving average, with trend line*



Source: British Retail Consortium (BRC)

Key findings this quarter:

- The Small Business Index (SBI) dropped to its lowest level on record as the extent of Britain's economic malaise became more obvious
- All areas of the UK except for the East of England reported falling business confidence, but even there the outlook remains negative
- The balance of businesses reporting falling revenues rose to the highest level since the first half of 2010
- In addition to current declines, revenue expectations for the coming three months have fallen to their lowest level yet
- A growing balance of firms has laid off workers, with the intention to reduce staff further becoming more widespread
- Business services, the financial sector and the computing and related industries are faring best amid the difficult economic environment. They are the only sectors reporting a mildly positive outlook
- Sectors dependent on consumer spending as well as those affected by high fuel prices suffered during the fourth quarter, with the transport related and the motor-vehicle related sectors both reporting a score below -50 points
- More than three-quarters of firms reported rising costs as inflation continued to put pressure on margins
- Commodity prices were the main drivers of inflation as fuel, utilities and inputs and raw materials were all cited by more than 40% of firms as driving up costs

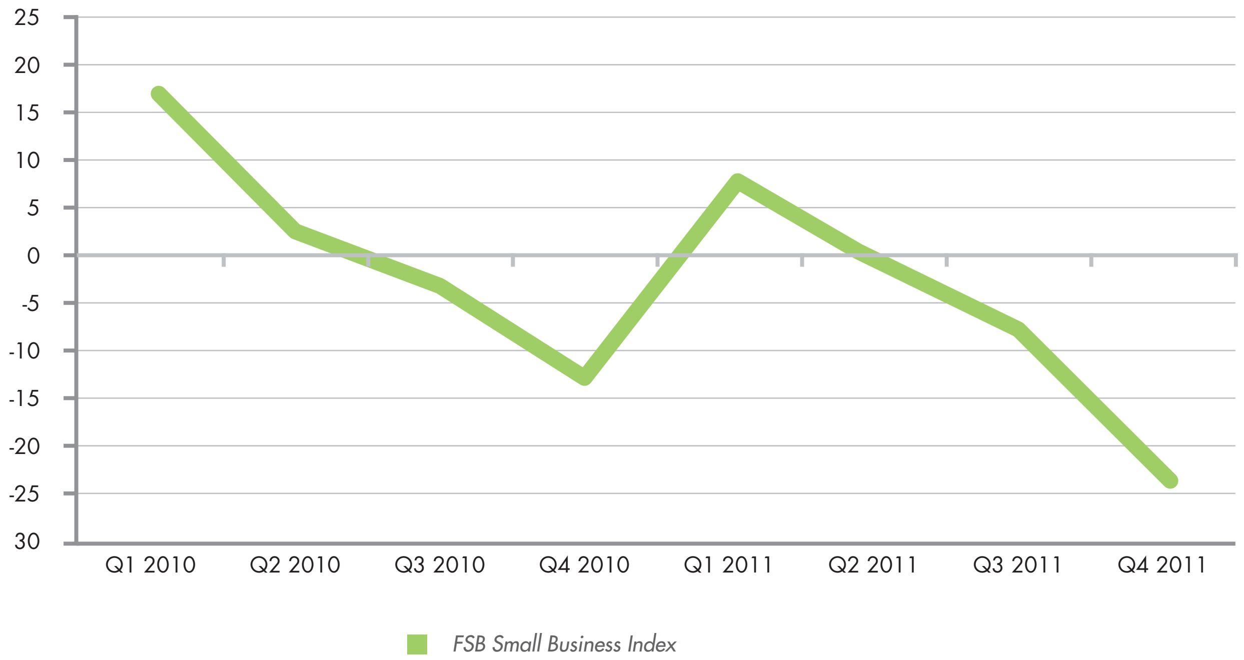
Small Business Index falls to record low

The FSB SBI fell sharply to -24.5 in the last quarter of 2011, a decrease of 15.2 points over the quarter. As Figure 2 shows, the reading marks the lowest level of confidence reported since the survey began in 2010, a sobering fact given the fragile economic outlook that partly relies on business investment to improve again. The SBI recorded a level of -13.2 at the same time last year, showing that business expectations have weakened considerably year-on-year as well as over the quarter as the eurozone debt crisis has dragged on.

The biggest driver of this quarter's deterioration can be found in the number of businesses expecting a much worse situation in the coming three months, which rose from one in 12 (8.6%) to one in eight (12.6%). Small firms expecting a slightly worse situation also became more numerous, rising from 25% to 27.3% while the number of firms anticipating a largely unchanged situation fell by 2.7 percentage points to 35.7%. Less than a quarter of small businesses (24.6%) now expect an improvement over the coming quarter.

The further decline in the SBI indicates that fourth-quarter economic growth is likely to be weak and may even be negative after the expansion seen in the third quarter. The previous close relationship of GDP growth and SBI results was broken in Q3 when a relatively healthy output expansion of 0.5% quarter-on-quarter was published. The healthy growth figures now appear unsustainable, however, with markets expecting a weak Q4 – a point underlined by some 1,600 responses to the latest FSB 'Voice of Small Business' Survey.

Figure 2: *The FSB Small Business Index[1]: small business prospects in three months' time – end quarter responses*



Source: FSB–RbD 'Voice of Small Business' Panel Survey (December 2011), sample size 1,653

[1] The Small Business Index is a weighted index of the responses to the question: 'Considering your overall business performance, and ignoring any normal seasonal variations at this time of the year, how do you view business prospects over the next three months, compared with the previous three months?' The share of firms reporting 'much improved' are given the following weighting: +2; slightly improved = +1, approximately the same = 0, slightly worse = -1 and much worse = -2; the Small Business Index is derived from the sum of these factors.

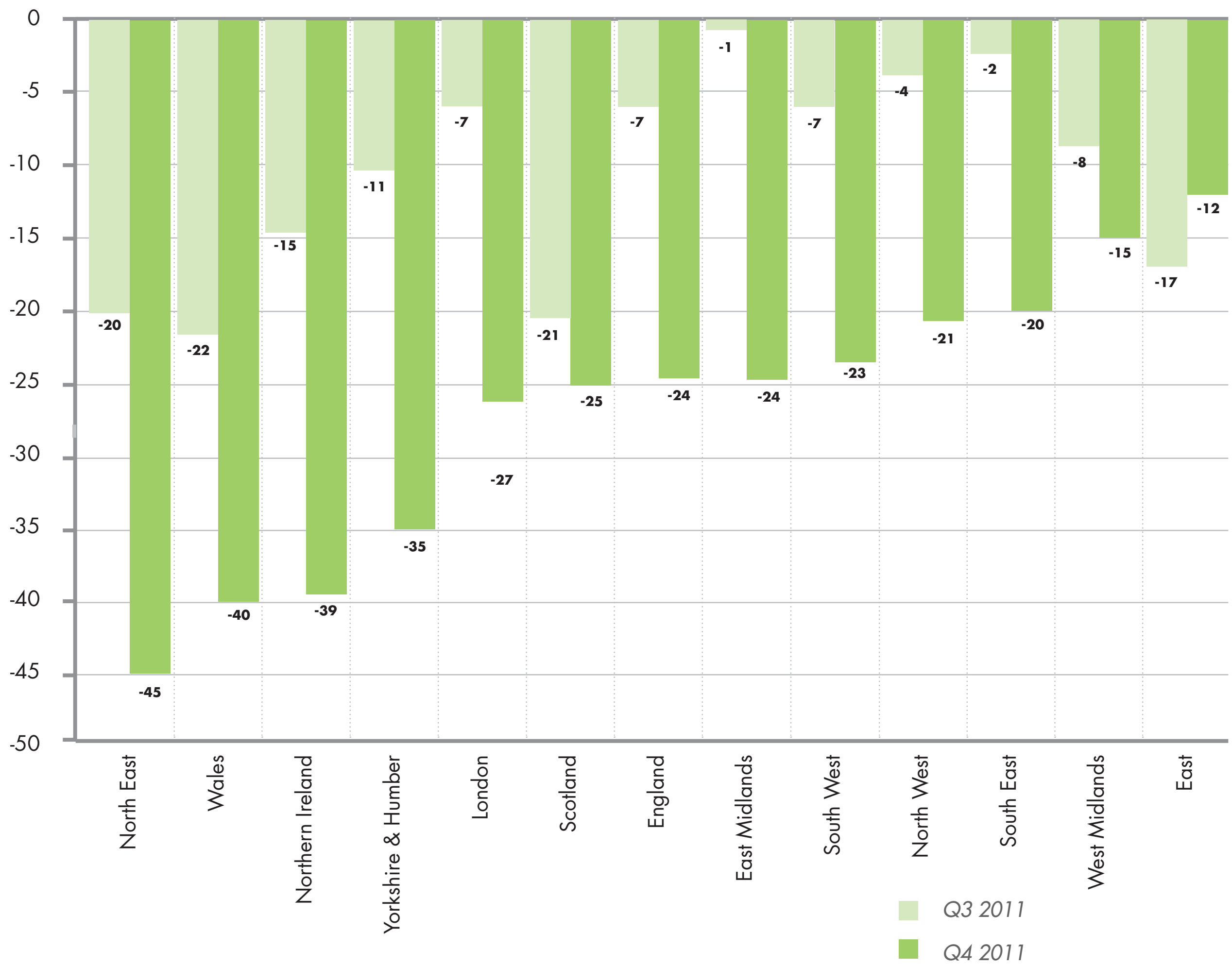
Small business confidence falls in all regions except the East of England

After turning uniformly negative across the country, business confidence dropped further in 12 of the 13 survey regions. Having fallen below a reading of -10 across the board, all regions now have a deeply pessimistic outlook for the coming three months. In the last edition of the survey, only about half of the regions had an SBI coming in below -10. Now they all do.

The peripheral regions continue to display some of the most downcast business confidence. With an SBI of -45, the North East is the most pessimistic, closely followed by Wales (-40) and Northern Ireland (-39). With an SBI of -35, Yorkshire and the Humber is the other region towards the low end of the spectrum. The scale of the decline in confidence is remarkable, since many readings were already low but in Q4 2011 have fallen by a similar magnitude again, as Figure 3 illustrates.

As the only region to report improved business prospects, the East of England bucked the trend as it improved its SBI by five points to -17. This may be linked to the strength of technology firms that prospered in the region and which have contributed to the East of England being the only part of the country outside London that has seen an increase in employment since the beginning of 2008. Despite its positive employment performance, London has actually fallen to the back of the class after it saw its index score plunge 20 points to -27. Further uncertainty in the financial services sector may be part of the reason for this decline, and this is set to accelerate in 2012.

Figure 3: *The FSB Small Business Index – regional variation in small business prospects in three months time – end quarter responses*



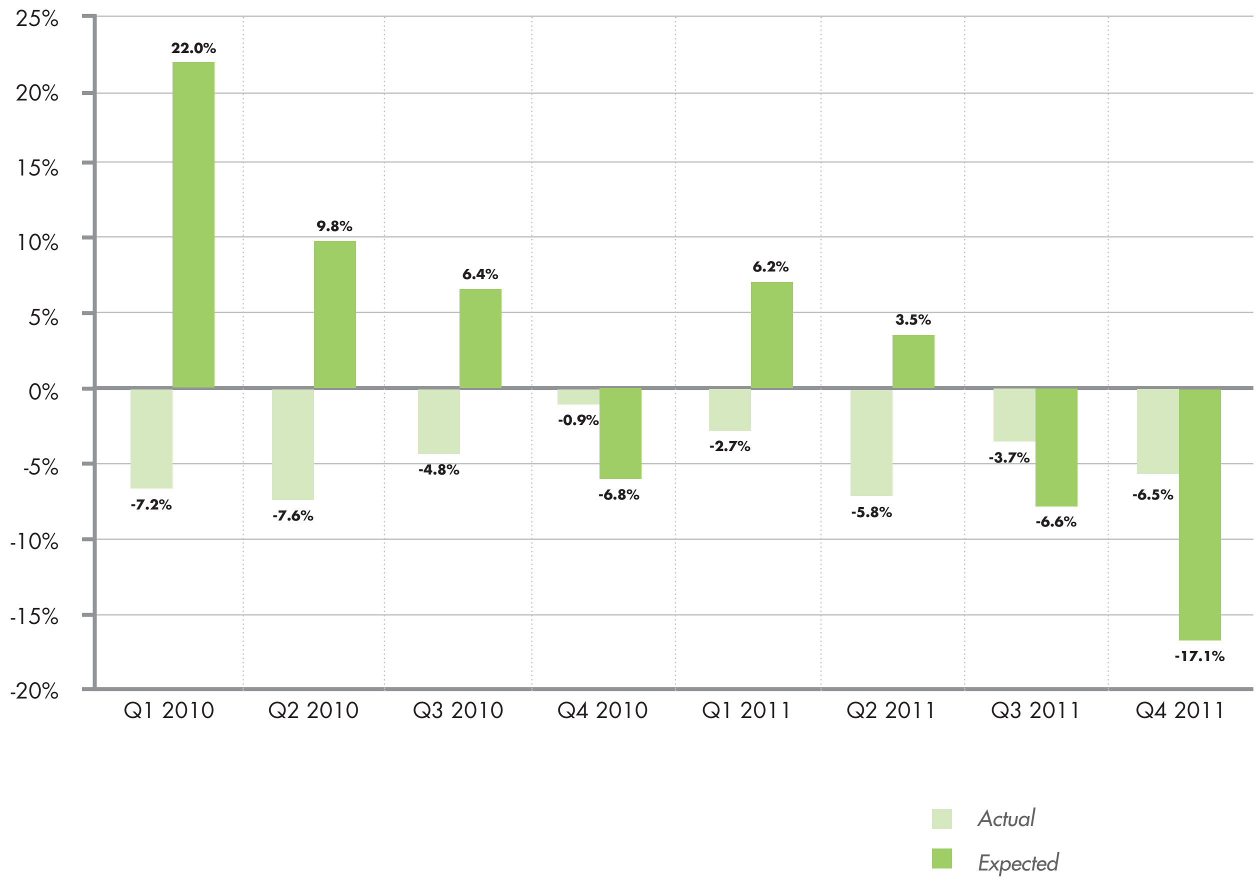
Source: FSB–RbD 'Voice of Small Business' Panel Survey (December 2011), sample size 1,653

Expectations of falls in revenue rise to highest level in survey history

In line with headline SBI results, small firms' revenue growth expectations have also fallen to the lowest level since the first edition of the report two years ago, when 17.1% more firms expected revenue to fall than to rise, a good 10 percentage points more than in Q3 2011. An emerging consensus that economic growth will be structurally lower in coming years is thus finding its expression in firms' more immediate outlook. Such pessimism may become a self-fulfilling prophecy if firms react by reducing staffing levels and by delaying investment, as this would help to create the economic conditions initially feared.

The general trend of revenue expectations has been down in this period as managers have gradually revised their outlook to better reflect deteriorating sales. The last quarter of 2010 had seen the prior minimum of revenue expectations, but was followed by a rather positive first quarter of 2011. Interestingly, Figure 4 reveals that firms have reported falling revenues each quarter. This was even the case in 2010, when UK GDP growth was higher than this year and also than it is forecast to be in 2012 and 2013. If history is any guide, we should expect to see a further sales decline in the coming quarters amid lacklustre economic growth.

Figure 4: *Small business revenue growth, net percentage balance – share reporting increase less share reporting decrease*[2]



Source: FSB–RbD 'Voice of Small Business' Panel Survey (December 2011), sample size 1,508

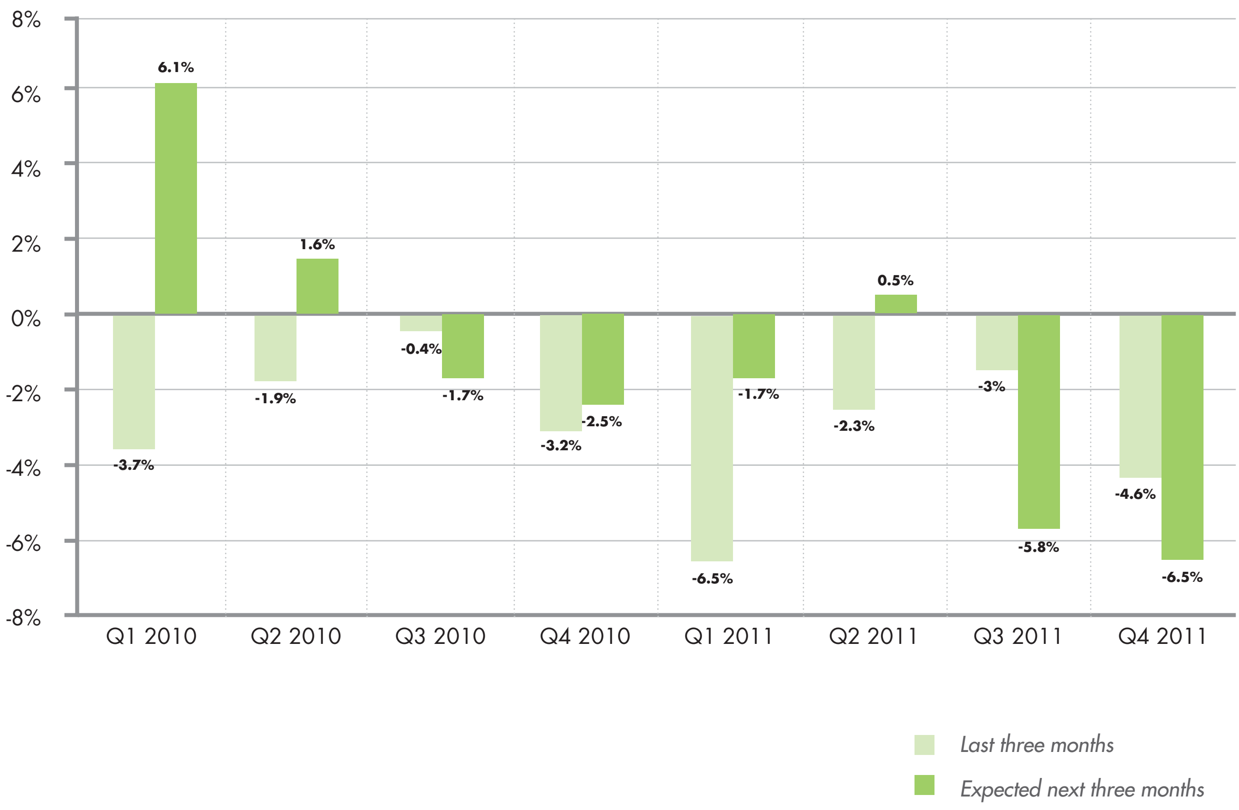
[2] For revenue all quarters refer to survey taken in the final month of the quarter with the exception of Q2 2010, when the survey was taken in May.

Small businesses to shed more jobs

The rising level of unemployment in the economy is evident in the survey responses, with a balance of 4.6% of small firms disclosing that they have reduced their headcount in the previous three months. This was slightly better than the 5.8% balance of firms expecting to lay off staff during the period, but higher than the 3.2% in the same period of the previous year. Figure 5 illustrates the deteriorating employment expectations trend.

A net balance of 6.5% of small businesses plan to lay off workers in the first three months of 2012. As with most other parts of the survey, employment expectations are at their lowest level yet. Given heavy staff cuts in the public sector and a steep rise in the number of unemployed workers (up 196,000, or 8.1%, between March and September), job losses in the Small and Medium Enterprise (SME) sector would compound a difficult UK labour market.

Figure 5: *Net percentage balance change in number of people employed – share reporting increase less share reporting decrease – end quarter responses[3]*



Source: FSB–RbD 'Voice of Small Business' Panel Survey (December 2011), sample size 1,604

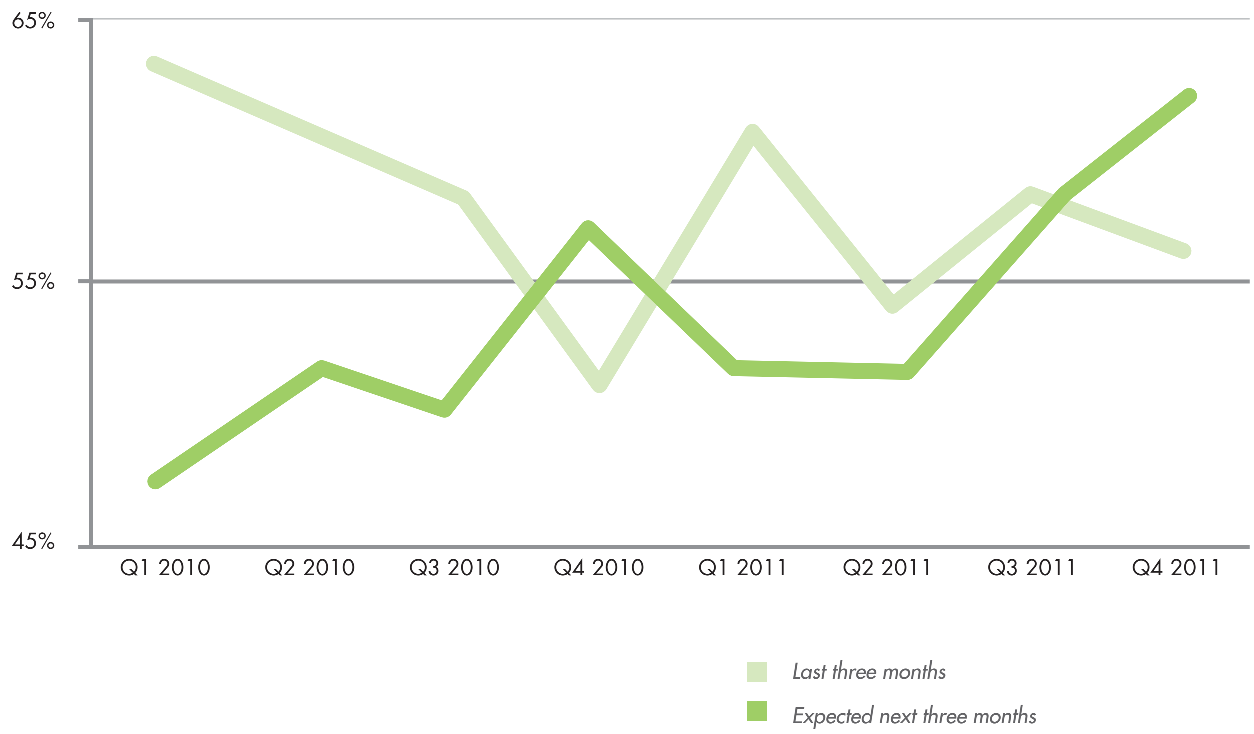
[3] For employment all quarters refer to survey taken in the final month of the quarter with the exception of Q2 2010, when the survey was taken in the first month of the quarter in April.

Spare capacity is expected to rise

Perhaps owing to the job cuts discussed, the amount of spare capacity has remained largely stable in Q4 despite the observed decline in sales. A balance of 56.2% of firms claim to be running below capacity, which represents a decline of 1.7 percentage points quarter-on-quarter (see Figure 6). Since the same time in 2010, the balance of firms with spare capacity has gone up 5.5 percentage points. Apart from the resulting job losses, rising spare capacity points to a lower level of investment in plant and machinery as firms have no need for fresh capital spending.

Spare capacity is expected to rise in the next three months as firms expect demand to weaken. Hitting its highest level yet, the balance of firms anticipating running below their productive capacity is set to increase to 61.9%. This level is above the 60% mark for the first time and is up 4.5 percentage points compared with Q3 2011. Since the beginning of the calendar year the increase is an even more notable 10.5 percentage points. An overall upward trend in spare capacity expectations can be observed since the inception of the survey in 2010. The actual balance of firms with spare capacity is fairly stable, however, possibly owing to downsizing in response to a deteriorating economic outlook.

Figure 6: *Net percentage balance of businesses running below capacity – share below capacity less share above capacity*



Source: FSB–RbD 'Voice of Small Business' Panel Survey (December 2011), sample size 1,586

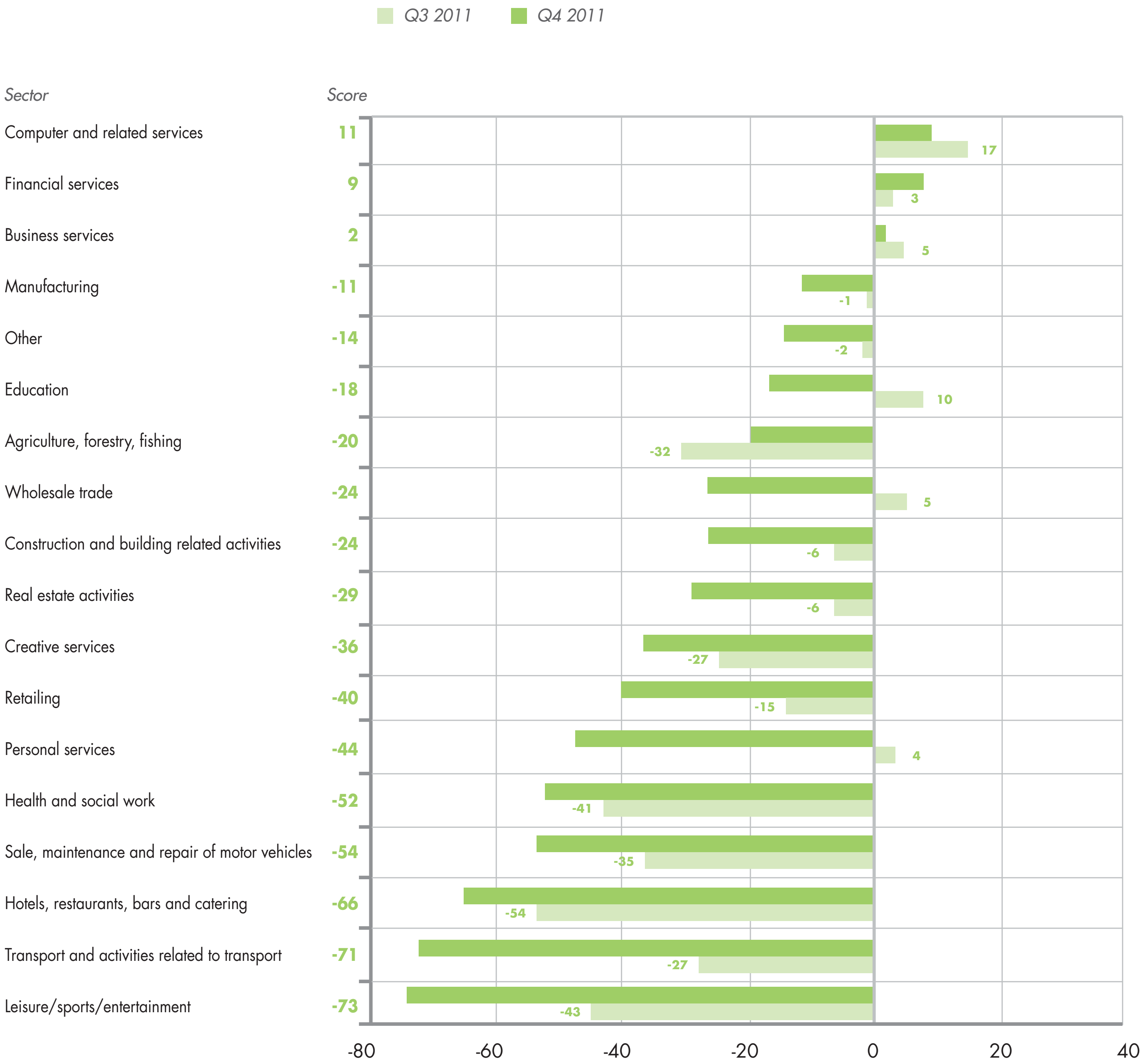
Frugal consumers weigh on industries that are dependent on discretionary spending

The almost uniform deterioration in economic prospects is also evident in the sectoral breakdown of the SBI. As Figure 7 shows, only three out of the 18 sectors report a positive outlook, down from six in the previous edition of the report. Between Q3 and Q4 the SBI improved for just two out of the 18 sectors. For the other 16, confidence fell, reaching unprecedented lows in some sectors.

The ones improving were two very different sectors: agriculture and finance. High prices for agricultural commodities appear to be giving a boost to producers despite the elevated oil prices which have a strong impact on margins in this energy intensive industry. At a reading of -20 in Q4, prospects are anything but bright, however. Financial services, on the other hand, remains in positive territory and saw a small increase in its SBI score, going from +3 to +9. This is somewhat surprising given the large scale lay-offs announced by several banks that are looking to trim staff and focus on their core business. SMEs' lower reliance on capital market transactions is an advantage, with the sector presumably benefiting from a positive environment for business services overall.

Computer services remain the most optimistic sector, now reporting an Index score of +11 after a result of +17 in Q3. Apart from finance and thriving ICT, business services are the only other sector in positive territory, albeit marginally so. Contrary to the business-to-business market, sectors reliant on disposable income have suffered steep declines. The leisure and hospitality trades reported SBI scores of -73 and -66 respectively, while personal services saw the biggest fall of any sector when it plunged from +4 to -44. Rising unemployment and the erosion of purchasing power due to high inflation and low wage growth have obviously hit these areas hard, as well as the retail trade. With fuel prices still high, transport and car-related businesses are also ailing, making up two of the bottom five sectors.

Figure 7: *FSB Small Business Index by sector – small business prospects in three months time – end quarter responses*

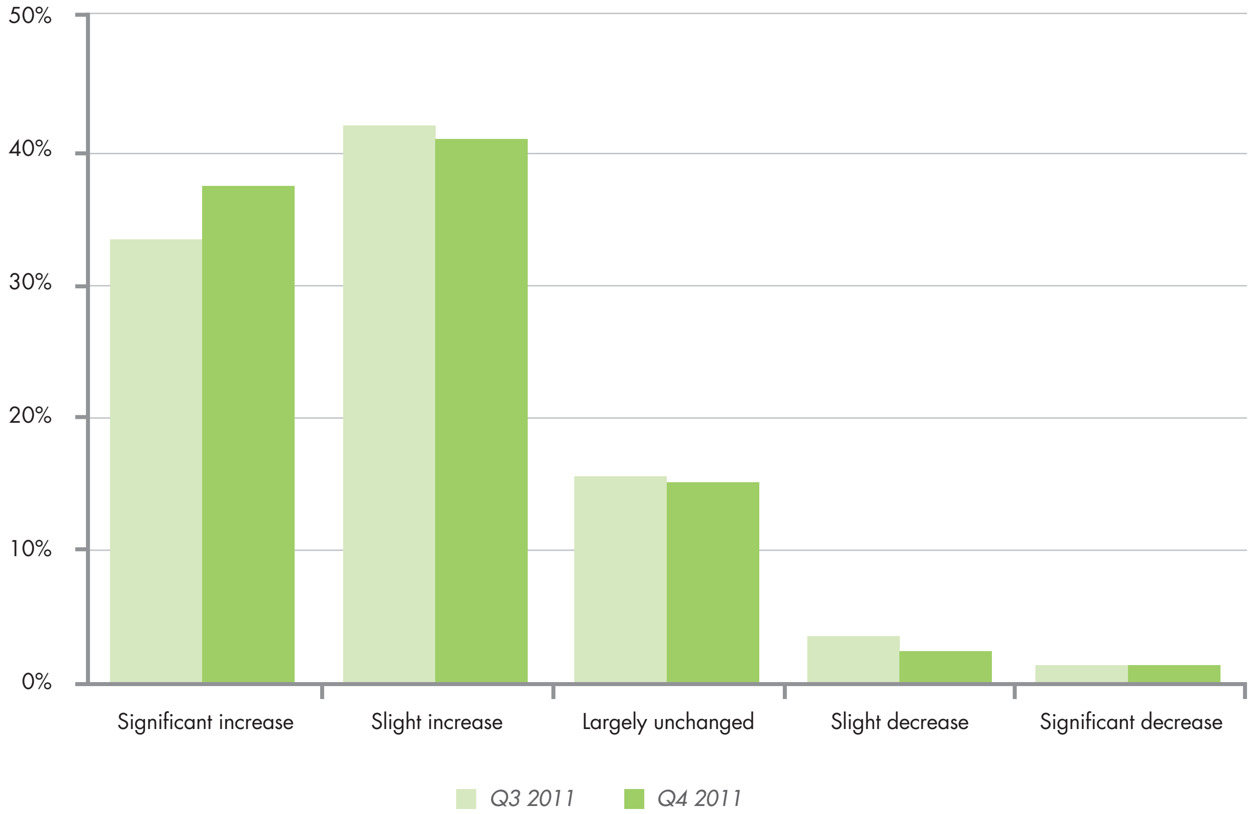


Source: FSB–RbD 'Voice of Small Business' Panel Survey (December 2011), sample size 1,653

Rising prices still affecting businesses despite slowing consumer price inflation

A rising proportion of small firms – 78%, up from 76.2% – saw their costs increase in the last three months of 2011 compared with the same period in the previous year. The increase derives from the 36.9% of firms saying that their costs had increased significantly, whereas those reporting a slight increase fell marginally to 41.1%. With the number of firms not noting major cost increases essentially unchanged, those saying that their costs had decreased became less numerous, as Figure 8 indicates. This group made up just 4.7% of firms, down from 6.2% in the previous quarter. High commodity prices continue to put pressure on small businesses and their margins at a time when revenues are falling and spare capacity is rising. Like consumers who face limited wage growth and high consumer price inflation, small firms are thus similarly being squeezed by the macroeconomic environment. Although revenue growth prospects are negative, at least inflation is due to come down sharply, with the possible exception of the oil price.

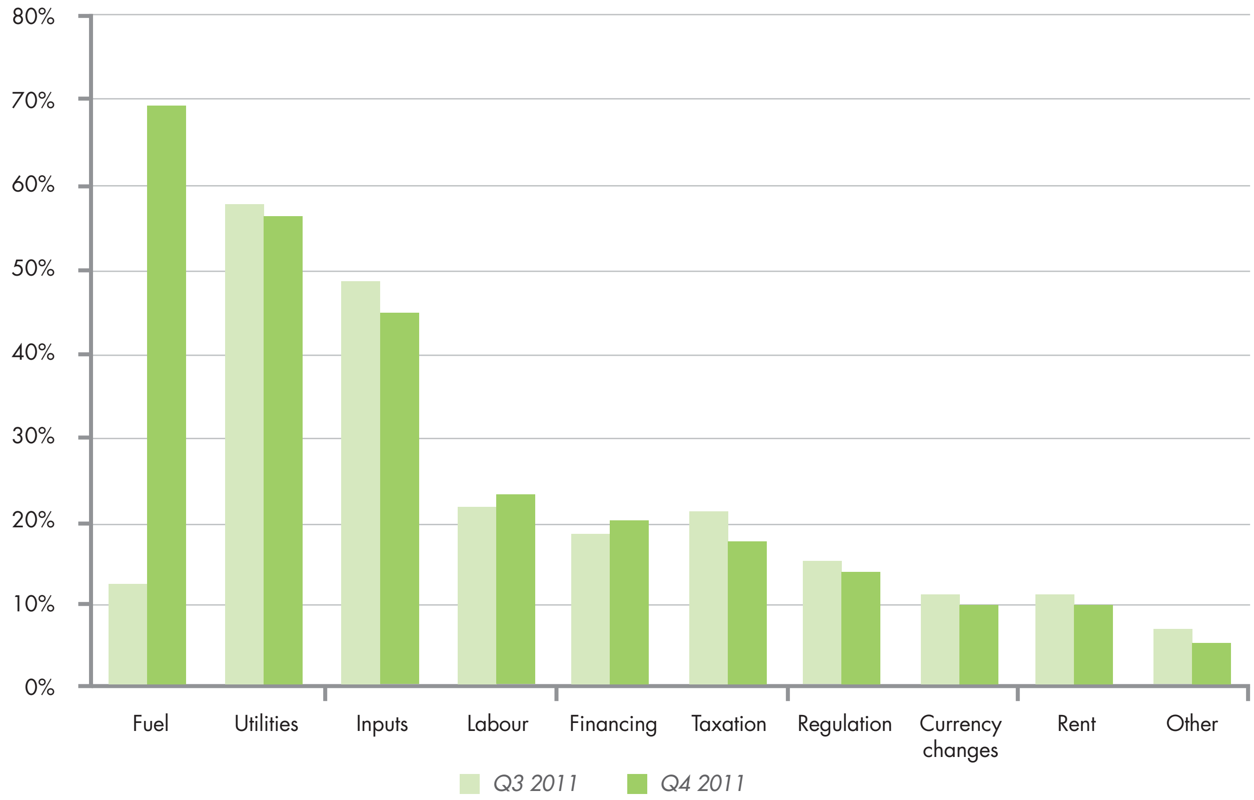
Figure 8: *Change in overall cost of operating the business – weighted by regional gross value added*



Source: FSB–RbD 'Voice of Small Business' Panel Survey (December 2011), sample size 1,668

Fuel prices shot to the top of the causes of inflation, going from 13% to 70% over the course of the quarter. This is puzzling because fuel prices had already reached a high level at the start of the year and have kept relatively stable since. So while the jump in responses is hard to explain, the upwards trend of energy prices is unambiguous. These relate closely to utility prices, which are the second most common factor cited as inflationary for small businesses at a stable 57% (multiple answers are possible). Easing input and raw materials prices are an indicator that inflation is levelling off among businesses in a similar manner to the consumer price index. As Figure 9 shows, the other cost factors were largely stable and unchanged from the Q3 responses.

Figure 9: *Main causes of increasing business costs – multiple answers possible*



Source: FSB–RbD 'Voice of Small Business' Panel Survey (December 2011), sample size 1,347

Methodology

All panel members (4,604) were invited to take part in an online survey. Reminders were sent to all non-respondents. 1,674 responses were received, a response rate of 36%. The data is weighted to the profile of small businesses across the UK and this accounts for the slight variation in results from the FSB 'Voice of Small Business' panel surveys. The survey was undertaken between 5 and 19 December 2011.

The data presented in this FSB-CEBR Q4 2011 report is weighted differently to the FSB reports and therefore the results may differ.

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