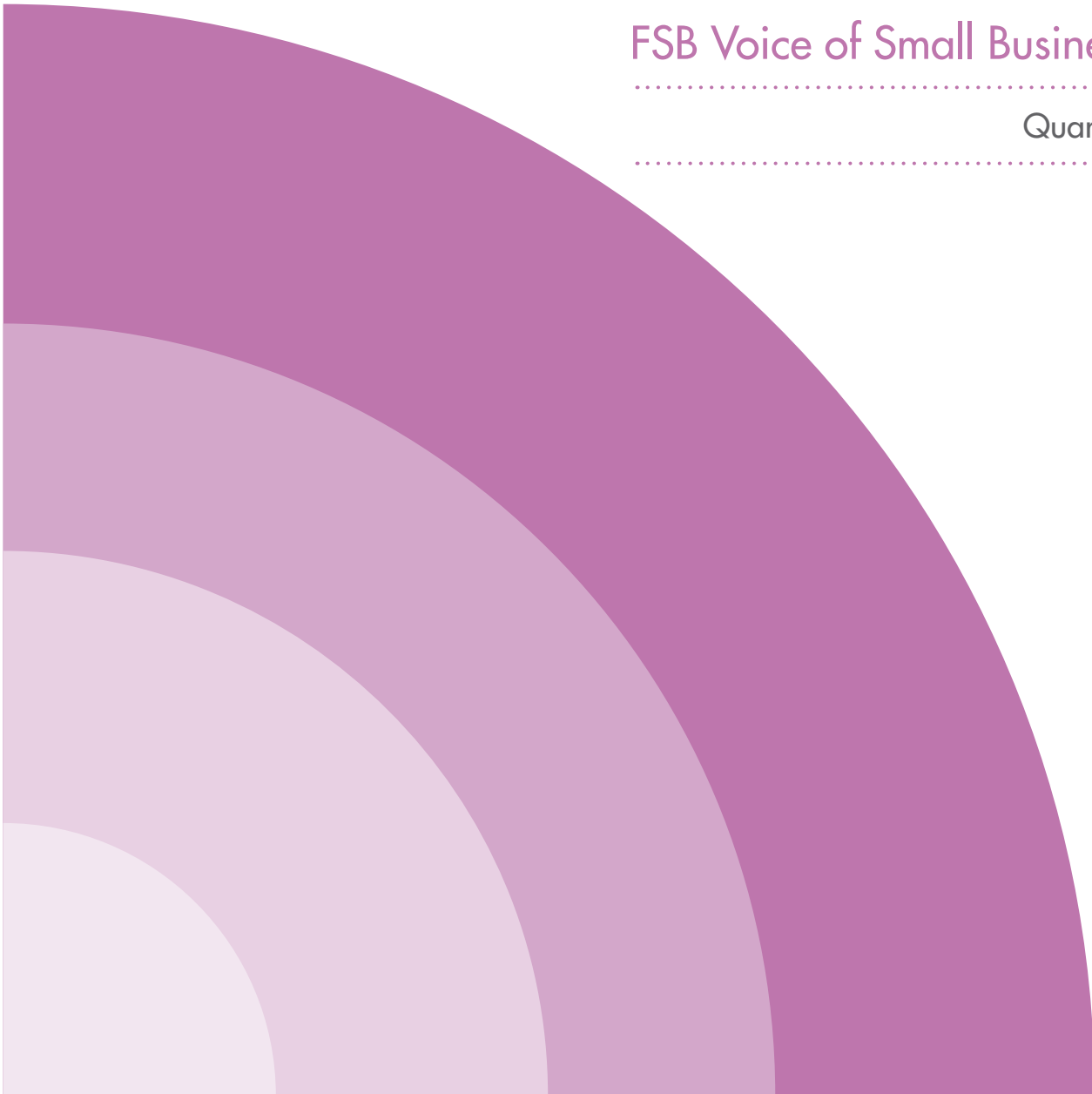




Federation of Small Businesses
The UK's Leading Business Organisation

FSB Voice of Small Business Index

Quarter 2, 2011



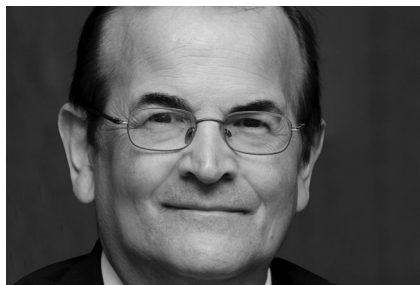
The Federation of Small Businesses (FSB) is the UK's leading business organisation. It exists to protect and promote the interests of the self-employed and all those who run their own business. The FSB is non-party political, and with more than 200,000 members, it is also the largest organisation representing small businesses in the UK.

The data presented in this FSB-CEBR Q2 2011 report is weighted differently to the FSB top line statistics and therefore the results may differ.

For more information please contact priyen.patel@fsb.org.uk

FSB Voice of Small Business Index

John Walker, FSB National Chairman



The Q2 2011 edition of the FSB 'Voice of Small Business' Index does not make for good reading for decision makers or small businesses. The main Index, which measures confidence amongst small businesses has now dropped to a score of almost zero and shows that small businesses, like the economy as a whole, have flat-lined.

For many small businesses revenue growth and expectation of higher turnover has dropped once again and we still see more small firms expecting to reduce workforce than increase it. This paints a negative picture of the UK economy and should be a concern for the Government. While domestic spending continues to suffer against the backdrop of higher than expected inflation and job cuts in the public sector, demand for goods and services from small businesses remains weak.

For this reason, the FSB does not believe the economy can sustain an interest rate rise, even if just a symbolic move, from the Bank of England. A rise in interest rates will not only harm spending by consumers through increase mortgage repayments but also make variable cost finance more expensive. It will also put off capital investment by small businesses due to the fear of finance becoming too expensive.

At the last Budget the Chancellor announced the cancelling of the fuel duty escalator, a 1p reduction in fuel duty and a form of fuel stabiliser where fuel duty will only increase by inflation when oil prices are high. Whilst this will give much needed help to hard pressed small businesses and motorists this is not the fuel stabiliser many have been calling for whereby high oil prices would trigger an actual reduction in fuel duty – something the Conservative Party mooted in opposition and that the FSB has been calling for.

Fuel is also a significant contributing factor to the current high level of inflation (CPI). A true fuel duty stabiliser would iron out the knock-on effects on inflation due to increases in the price of oil and act as a break on inflation limiting the damaging effect inflation has on our economy.

A fuel duty stabiliser would not only help stabilise the finances of households and small businesses but that of the wider economy as well.

Additionally, the FSB wants to the Government to explore the use of targeted VAT cuts in the construction and tourism sectors to help growth. Cuts in VAT in these sectors, with a time limited period, would not only boost trade in these sectors but also for the wider economy. Other nations have proactively used VAT to help stimulate economic activity and have chosen these sectors – as should the UK Government.

The FSB 'Voice of Small Business' Index shows some relatively positive outcomes in the small business labour market. Outlook turned mildly positive as hiring expectations for the next three months have become marginally positive, rising to the highest level since Q2 2010. However, with more businesses still expecting to reduce workforce than those expecting to increase, we see signs of static national employment trends. ONS figures show that top line unemployment figures continue to reduce, albeit very marginally, but that the numbers of people on job seekers allowance; being made redundant; and who are long term unemployed (six months) continue to rise.

Economist's View – Charles Davis, Managing Economist, cebr



The latest edition of the quarterly FSB 'Voice of Small Business' Index sees the economic sentiment of the 1,622 respondents fall back after a fairly strong result in Q1 2011. The headline Index, which quantifies the expectations for business conditions in the coming three months, dipped to 0.3 in Q2 2011 from 6.7 in Q1. This is close to the zero mark that indicates stagnation, and is some way below the 2.8 figure of Q2 2010, when the UK was recovering from the immediate effects of the global financial crisis.

A reduction in the Index from Q1 2011 indicates that it is in line with an apparent slowing of output after the first-quarter bounce, which was driven by the delayed activity following bad winter weather, a royal wedding that boosted confidence and warm spring weather that temporarily boosted retail spending. It appears that

limp domestic demand and budget austerity are catching up with small firms as economic indicators such as retail sales, employment and industrial production sag. More small businesses have lowered their expectation of revenue increases accordingly, with now only 3.5% more firms expecting sales to rise rather than decline.

The sector outlook offers an interesting perspective on the UK economy in the foreseeable future. The weak pound, which is likely to remain at a low level owing to the Bank of England's accommodative monetary policy, supports the manufacturing sector. UK-made products have become a more attractive proposition and, as time goes by, the high cost of imports is likely to result in some import substitution. This represents a reversal of fortune for the long-suffering UK manufacturing industry and offers a real chance of revival for the sector that was once a world leader, but whose share of the economy has been shrinking for decades. The strong performance of financial and other professional services suggests that the UK has left the immediate effects of the financial crisis behind, with the business area in which it enjoys an international

competitive advantage blooming again.

From a regional perspective, these developments support regions such as the Midlands and those areas of England with close links to London. On the flip side, Northern Ireland, Scotland, Wales and the North East are suffering from reduced consumer spending, reflected in a negative reading for the Small Business Index in all these regions. This regional disparity is likely to be an ongoing theme, compounded by government spending cuts that will probably weigh most heavily on the more fragile regions. As the austerity drive gathers pace (so far there has been more rhetoric than actual cuts), the public discontent recently manifested in a public-sector strike is likely to spread. Small businesses in areas dependent on consumer spending and on the UK's 'periphery' will have to adjust to a period of slow growth during the next two or three years before the economic picture brightens again.

On the whole, I believe that small businesses have taken a smart decision by reducing their spare capacity to pare back their cost structure in preparation for a lean period. We will most likely

¹ Notably the CIPS/Markit Purchasing Managers Indices have bounced back strongly in Q1 2011 while Bank of England, CBI and European Commission data have also improved.

have to wait for some time until a resurgence of domestic demand allows small businesses to increase their workforce and again become the motor of the UK economy.

UK Macroeconomic Update

Growth forecasts keep falling as real-income squeeze leads to falling consumption

Economic commentators have been revising their 2011 UK growth forecast steadily down in recent months as high unemployment, a moribund housing market and stagnating wage levels amid high inflation restrain domestic consumption. An unexpected fall in manufacturing output in April added to concerns, and a public sector strike gave a taste of the looming discontent over public sector cuts that have yet to start in earnest.

Although inflation remains at more than double the Bank of England's policy target, the large slack in the economy will probably keep the Monetary Policy Committee from raising rates in the near future – probably not until Q2 2012.

Looking ahead, reduced government spending is projected to hold back economic growth for the next few years. It may well not be until

2013 that increasing demand from consumers will start to contribute significantly to economic growth. This year and next, a positive net trade contribution due to the low value of sterling will be the main driver of growth, but this should level off as domestic demand and resurgence in investment take over as growth drivers.

The retail sector will be one of those

Figure 1: Evolution of 2011 UK GDP growth forecasts - Office for Budget Responsibility, average of independent forecasters and Centre for Economics and Business Research



Source: HM Treasury, Cebr

hit hardest by persistently high unemployment. With credit-driven consumption a thing of the past, consumer spending should be more closely tied to wages, limiting the upside potential for most of the sector. Financial intermediation, on the other hand, is projected to do rather well, as it represents the UK's most internationally competitive product. This implies that financial centres such as London and Edinburgh are likely to do comparatively well,

whereas Wales, Northern Ireland, most of Scotland and the North East will lag further behind.

Key findings this Quarter:

- The Small Business Index declined to a level that indicates stagnation in the coming three months, reflecting the effects of an ongoing sluggish recovery
- Small business confidence continues to lag behind in Northern Ireland and the North East, whereas the East Midlands and the South of England show most optimism
- More firms reported falling revenues in the three months to June than in Q1 2011, the lowest since Q2 2010
- As in each previous edition of the Survey since 2010, more firms saw sales fall than rise
- In Q2, the second-lowest balance of firms expecting higher turnover in the coming three months was reported since the Survey's inception
- The small business labour market outlook turned mildly positive as hiring expectations for the next three months have become marginally positive, rising to the highest level since Q2 2010
- The number of firms reducing staff declined, although more firms are still laying off workers than hiring new ones
- The personal services and financial services sectors were the most optimistic about the next three months, followed by a manufacturing sector that is benefiting from a weak sterling exchange rate
- High fuel costs and declining real incomes have affected the prospects of transport-related companies and the retail sector
- As expected, the number of firms with excess capacity moved back down after a spike in the first quarter, closing the gap to the capacity level that businesses anticipate in the next three months

Small business confidence points to stagnation in the second quarter

The FSB Small Business Index dipped to 0.3 in the second quarter, reflecting a less optimistic outlook for the coming three months. While still pointing towards a marginal expansion next quarter, the fall from Q1 2011 implies stagnation. After falling 6.4 points in the quarter, the Index now stands 2.5 points lower than one year ago.

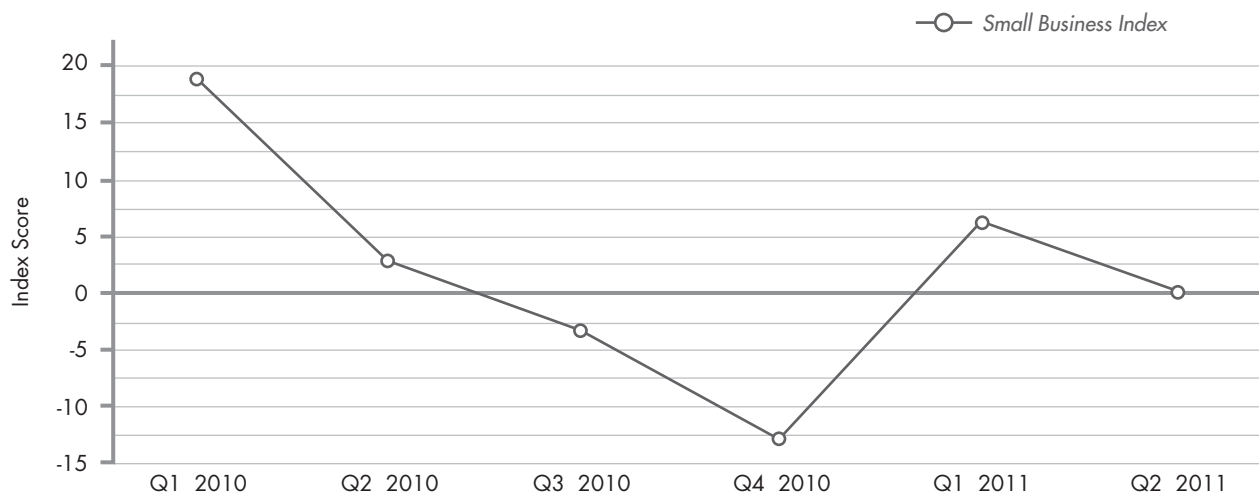
The number of businesses reporting a much worse outlook outweighed that of firms expecting a much improved situation by about two to one. This was the fifth successive quarter in which strong negative responses outnumbered much

improved ones. Moreover, just 3.9% of respondents envisage their situation improving substantially over the coming quarter – the fewest since the inception of the Index. These figures illustrate the growing pessimism of British business in an environment characterised by high inflation, high unemployment and muted domestic demand.

The dip in the fourth quarter Small Business Index accurately forecast an overall decline in the UK's output for the quarter, while the rebound for the second quarter was anticipated by a return into positive territory in the Index. Looking ahead, this

implies that economic growth will stagnate in the second quarter. Other leading indicators such as the Chartered Institute of Purchasing & Supply's Purchasing Managers' Indices have been pointing in the same direction, together painting a sluggish picture of UK growth this year.

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 (June 2011); sample size 1,622

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 weightings: +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.

Areas near London upbeat, but rest of UK has gloomy outlook

In line with the general turn towards a more cautious outlook, regional business confidence declined in most areas of the United Kingdom. There is a clear divide between England (except for the North East) and Scotland, Wales and Northern Ireland. While the more prosperous areas of the UK continue to do reasonably well, the regions with lower incomes generally take a dim view of their business prospects. With the Small Business Index standing at 0.1, London is close to

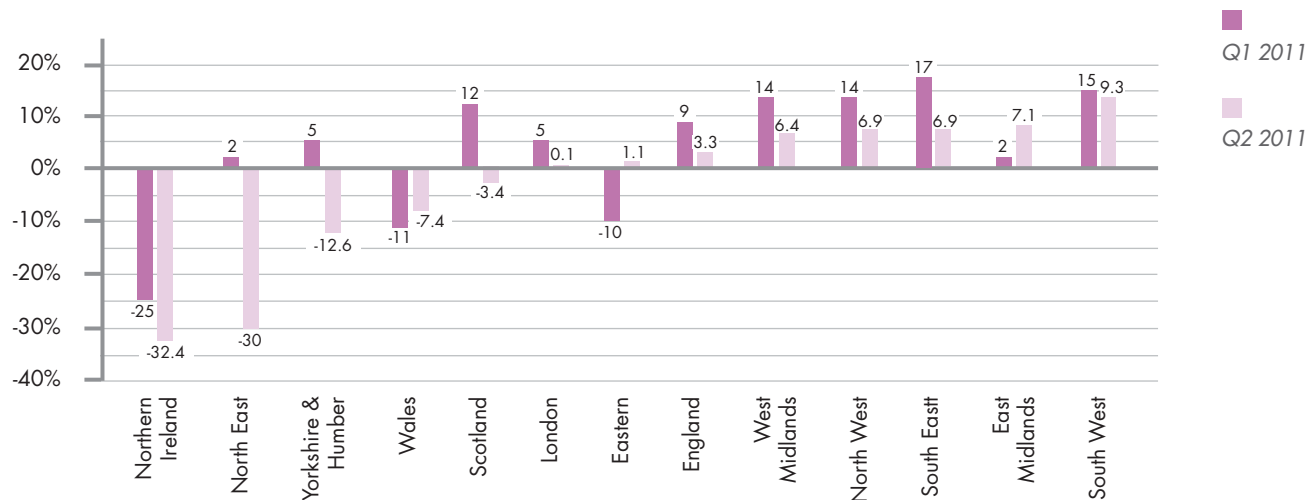
the national average for its business outlook. This is somewhat surprising, given the quick economic rebound after the financial crisis and the fact that house prices are still rising in the capital, probably supported by demand from overseas.

The regions with a higher Small Business Index score include the South of England and those areas with a strong manufacturing base, such as the Midlands and the North

West. Except for the East Midlands, all these regions reported a lower Small Business Index than in Q1 2011, however, meaning that they are not immune to the overall malaise of the UK economy.

The most extreme shift of sentiment occurred in the North East, where the Small Business Index fell back from a reading of 2.0 to a deeply negative -30.0. Only in Northern Ireland were businesses more

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 (June 2011); sample size 1,622

downcast in their responses, with an Index of -32.4 signifying a further deterioration in economic optimism, which was already at the low end of the spectrum. Scotland and Yorkshire & Humber fell back into negative following modestly expansionary expectations in Q1. Although Wales improved modestly from -11 to -7.4, below-zero readings for the entire 'periphery' of the UK economy show that a large part of the UK looks set to suffer economic hardship at the same time as the Coalition

Government cuts back on the public expenditure that these regions are especially reliant on.

Revenue expectations fall in line with weaker business confidence

In line with generally diminished sentiment, revenue growth expectations were revised down by small businesses. Firms still expect an increase in sales for the coming three months, but a balance of just 3.5% is the lowest expectation in the series so far except for a negative value in Q4 2010, and represents a fall of nearly half from the Q1 2011. The general trend since early 2010 has been downwards, possibly reflecting the realisation that the heady days of robust

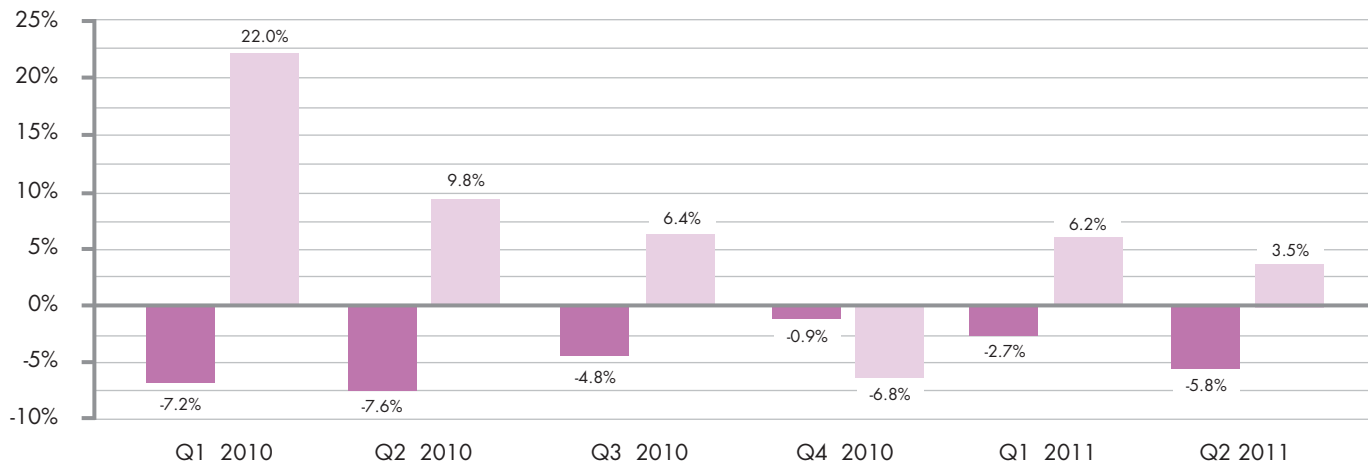
pre-crisis economic growth have passed for good.

Figure 3 illustrates that business owners tend to be optimistic about the outlook for their enterprise. Since the start of 2010, only in Q4 2010 was there an expectation of revenues declining in the coming three months. In fact, small businesses have suffered a fall in revenue each and every quarter. The second quarter showed a decline for a significant number of firms:

5.8% more firms said that revenues had been falling compared with Q1 2011 than reported rising sales. While not a huge negative balance as such, falling revenues for the preceding five quarters amount to a serious cumulative fall for small firms. The decline in Q2 2011 represents the steepest reported fall since Q2 2010.

With high food and energy price inflation forcing consumers to spend a larger proportion on essential

Figure 4: Small business revenue growth, net percentage balance: share reporting increase less share reporting decrease²



Source: FSB- RbD 'Voice of Small Business' Panel Survey (June 2011); sample size 1,469 - 1,622

² For revenue all quarters refer to survey taken in the end month of the quarter, with the exception of Q2 2010 where the survey was taken in May

items, the falling revenue trend in the retail sector is likely to carry on for an extended period. Additional headwinds for the economy include disappointing recent industrial production and public austerity measures, set against a backdrop of a slowing global economy. These developments are likely to make it difficult for firms to increase their turnover, probably resulting in another quarter of falling revenue in Q3 despite the modest improvement hoped for by small businesses.

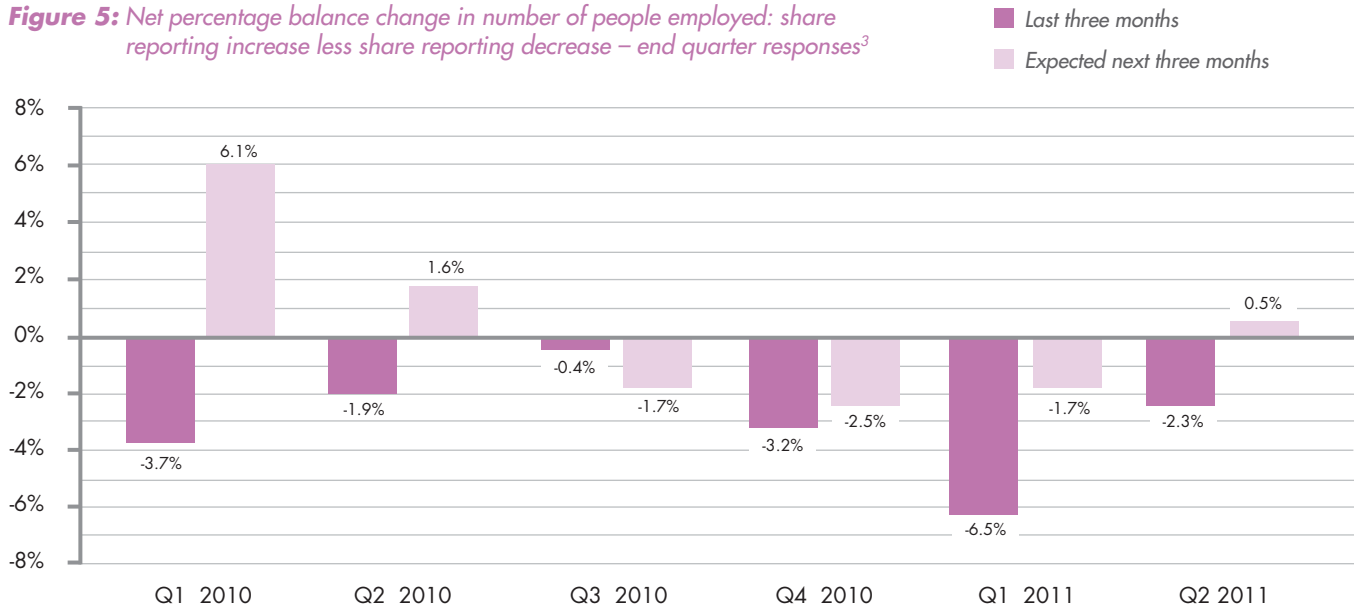
Employment expectations up, but balance of firms still cutting jobs

Small businesses continued to reduce the size of their workforce in the three months to June as falling revenues apparently forced a reduction in operating costs. The decline was less marked than in Q1 2011, with a balance of 2.3% more firms laying off workers than hiring new staff. The development of the survey responses this year mirrors developments in the UK labour market, which has seen the unemployment benefit claimant count rising from 1.45 million to 1.49 million since February 2011.

A marginally positive reading of 0.5% more firms looking to hire than to lay off may indicate a stabilisation of the labour market, albeit at the current elevated level of unemployment. It is the first time in a year that the balance of firms expecting to hire has been positive, but the relatively low level of hiring expected means that this should be treated as only a cautious sign of an improving employment situation, especially given the challenging business environment and sluggish

domestic demand. Moreover, the net balance is lower than during the same period last year, when it stood at 1.6%.

Figure 5: Net percentage balance change in number of people employed: share reporting increase less share reporting decrease – end quarter responses³



Source: FSB- RbD 'Voice of Small Business' Panel Survey (June 2011); sample size 1,282 - 1,353

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

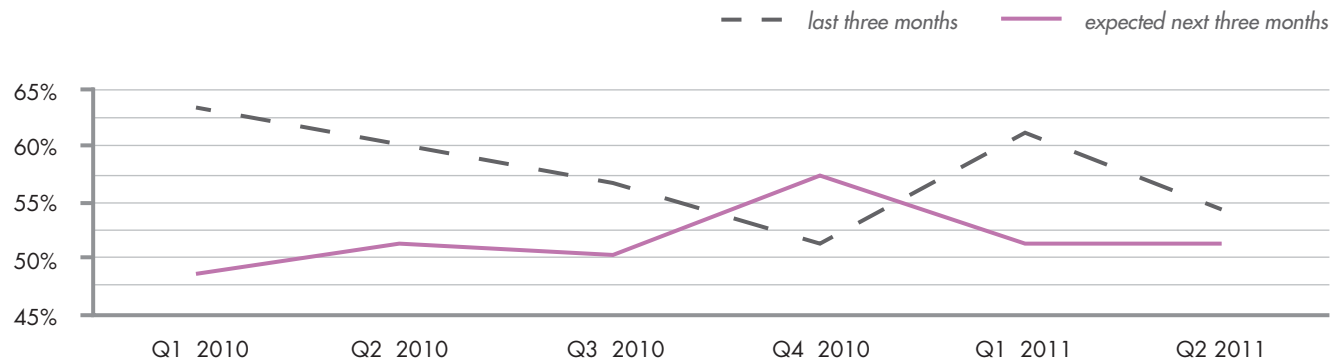
Spare capacity falls back towards trend line after last quarter's bounce

The balance of businesses with spare capacity in the three months to June compared with those operating above capacity declined by around six percentage points to 54.5%. Given the decrease in revenue, this implies that firms have been cutting production capacity during the quarter. A reduction in staff numbers confirms the view that lower excess capacity has been brought about by fewer resources being employed rather than by higher utilisation.

The balance of expectations held largely steady, falling just 0.1 percentage point to 51.3%. This means that most small businesses continue to maintain their production capacity in the hope of rising sales. This evidence of significant spare capacity in the British economy supports the Bank of England's case for maintaining the current loose monetary policy. Interest rates are likely to rise only when the output gap (i.e. spare capacity) begins to close and domestic price pressures force

a tightening of rates. This, however, is unlikely to occur before 2012.

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 (June 2011); sample size 1,547 - 1,625

Manufacturing and professional services expect expansion, but high inflation hits transport and retail sectors

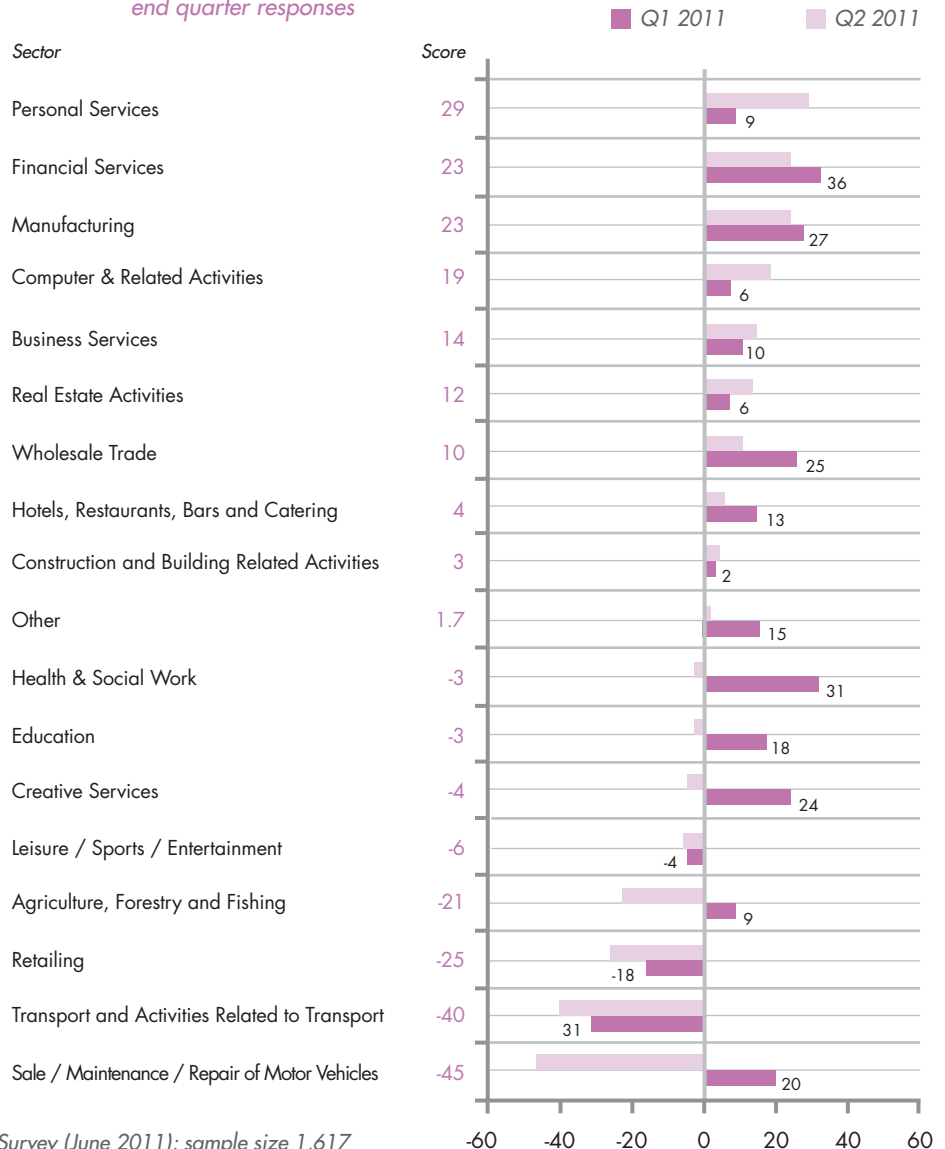
On a sectoral basis, there have been reversals in expected business conditions for a number of industries. On the whole, service industries were more upbeat than other parts of the economy. The FSB Small Business Index declined for 13 out of the 18 sectors, reflecting the broad-based deterioration in the business outlook for the coming three months. Five sectors went from a positive to a negative reading.

Personal services saw the biggest improvement, taking the Small Business Index from a reading of 9 to 29. The second strongest area is financial services. Contrary to predictions, the financial services sector has been remarkably buoyant in the aftermath of the financial crisis. With an Index of 23, it was ahead of other business services. One surprise is the presence of real estate activities in the upper third of sectors despite falling house prices.

Thanks to a weak pound, manufacturing has been benefiting from strong export growth. Sterling is likely to remain at a low level for some time, which should support the sector via both foreign sales and a limited substitution of imports that are conversely rising in price.

(continued overleaf)

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



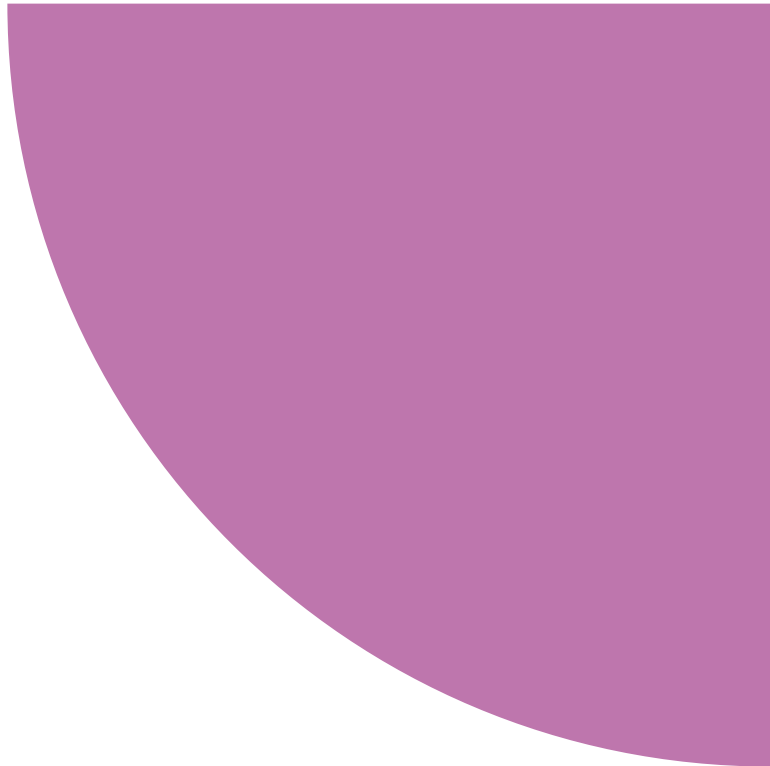
Source: FSB - RbD 'Voice of Small Business' Panel Survey (June 2011); sample size 1,617

Consumer-focused areas that rely on disposable income, such as leisure / sports / entertainment (from -4 to -6) and retail (from -18 to -25), are increasingly pessimistic, as high inflation coupled with low wage increases cut the population's purchasing power.

Sectors affected by the high oil price have dropped to the bottom of the spectrum as regards the three month outlook. The Small Business Index for the transport sector fell from -31 to -40, but the most drastic reversal came for the motor vehicle related sector. Its Small Business Index lost a whopping 65 points, going from 20 to -45 since the first quarter. With squeezed incomes and high fuel prices, these areas are likely to face a difficult environment for the next quarters and will have to learn to grapple with sustained high energy costs.

Methodology

This report is based on the June 2011 FSB Voice of Small Business Panel Survey of FSB members, carried out by Research by Design. All panel members 4,436 were invited to take part in an online survey. Reminders were sent to all non-respondents. A total of 1,622 responses were received, a response rate of 37%. 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 13 and 24 June.



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