



Federation of Small Businesses
The UK's Leading Business Organisation

FSB Voice of Small Business Index

Quarter 2, 2010



The Federation of Small Businesses is the UK's largest campaigning pressure group promoting and protecting the interests of the self-employed and owners of small firms. Formed in 1974, it now has 213,000 members across 33 regions and 194 branches.

The data presented in this FSB-CEBR Q2 2010 report is weighted differently to the FSB-ICM reports and therefore the results may differ.

FSB Voice of Small Business Index

John Walker, FSB National Chairman



The FSB represents 213,000 small and medium-sized businesses across the UK. The FSB 'Voice of Small Business Index' comes after the general election and the emergency budget which have changed politics and the approach to the economy. The coalition government has accelerated the deficit reduction plan, which was put in place by the previous government, and enlarged the total planned reduction. As the public sector reduces in size and approach, the private sector, especially small businesses, will need to be able to absorb people and demand.

The government now needs to look at how the private sector can play the major role in rebalancing the economy and providing jobs for those who leave the public sector.

We also need to see tangible help for small businesses to employ more staff, and as such, endorse the plan for a National Insurance Contribution holiday for new businesses to employ staff. We encourage the government to move further and promote this policy to existing businesses as well.

From our findings this quarter, we find that a strong recovery is still some way off. A double dip recession is now looking unlikely (based on current policy) but growth at the levels which the UK needs to fully recover seems to be out of reach. The expected unrevised GDP figures for quarter one 2010 show that growth between January and March 2010 was only 0.3%. This slow growth is disappointing when one considers that the economy contracted by 6.4% between the second quarter of 2008 and the third quarter of 2009.

The small business community continues to report under capacity and this is more prevalent within the service sector. Additionally, revenue growth remained weak and is expected to stay weaker

than in previous surveys. While the recession is technically over, many small businesses are still suffering from a lack of demand and difficult credit access issues. British Banking Association figures show that the 2010 monthly average of term lending (change on previous month) is -£145million, compared to £69million in 2009 and £303million in 2008.

Looking forward to the next quarter and the rest of 2010, we expect to see weak growth continue throughout 2010 and through to the middle of 2011. This is in light of the public sector rebalancing and the major downsizing of the UK's budget deficit. We continue to press the government for more encouragement for small businesses to grow and take on more staff. Economic recovery and rebuilding the nation's balance sheet will need flexibility and tax freedom for small businesses.

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



The FSB 'Voice of Small Business Index', based on a June survey of 1,216 small businesses, and earlier monthly surveys, suggests that business sentiment across the UK has faltered through the second quarter of 2010. Only a net 4% of small businesses believe that business prospects will be better in the three months from June, compared with 16% in March. The UK economy grew by 0.3% in the first quarter of 2010 and while the backward looking indicators imply growth could have been stronger at around 0.6% in the second quarter, this latest evidence points to a potential slowdown in the pace of recovery.

The June survey suggests that almost 67% of small businesses are operating below capacity. Although this is down from 70% in the March survey, it suggests the UK economy is still some way from

full speed. This has key implications for inflation and monetary policy in the coming months. While inflation reached a peak of 3.7% in April and inflation expectations reached their highest level since the commodity price-driven bulge in inflation through 2008, inflation fell back in May and the FSB survey suggests the UK economy is by no means in danger of overheating. As such, inflation is expected to fall back, albeit bumpily through the second half of 2010. The VAT rise to 20% in January 2011 will limit the downward momentum on prices but the public sector cuts will reduce overall demand in the economy and add to spare capacity in the labour market.

The survey suggests that there are important regional and sectoral differences in business over and under-capacity. In particular, the survey finds that a greater proportion of manufacturing businesses are running at or above capacity at present, compared to services. This is consistent with other survey findings for June and July which found that services were recovering more sluggishly than manufacturing. When making a regional comparison, we find that business under-capacity is greatest

in the South East. This may be, in part, due to the region's historic dependence on the service sector.

It is not clear for how long manufacturing will continue to outstrip service sector growth, especially as public sector spending cuts in response to the sovereign debt crises in the eurozone could both curb demand for UK exports (approximately 50% of which go to Europe) and trigger an appreciation in sterling against the euro, making UK exports less price competitive.

Overall, the consensus view in the small business community is that a strong recovery is far from secure, and that there are significant downside risks to business growth in the near future. This is a view that cebr share; our projections for growth are weaker than the Office for Budget Responsibility in 2011 and beyond. Moreover, given the spare capacity and scale of fiscal consolidation ahead, we think that interest rates will have to stay lower for longer to accommodate this. With around 600,000 public sector jobs expected to be lost, stimulating private sector job creation will be vital to the UK's economic rebalancing act.

Key findings this Quarter:

- The June survey found that small business confidence has faltered since March. Fewer small firms believe that business prospects will improve over the next three months than did in March, and more businesses believe that prospects will be worse.
- The majority of small businesses are still operating below capacity, although the proportion of businesses below capacity has fallen slightly from 70.5% to 66.6%.
- Under-capacity is more prevalent amongst service sector businesses than manufacturing/industry sector businesses.
- Revenue growth remains weak across small businesses, while expectations of future revenue growth are weaker than in the previous survey.

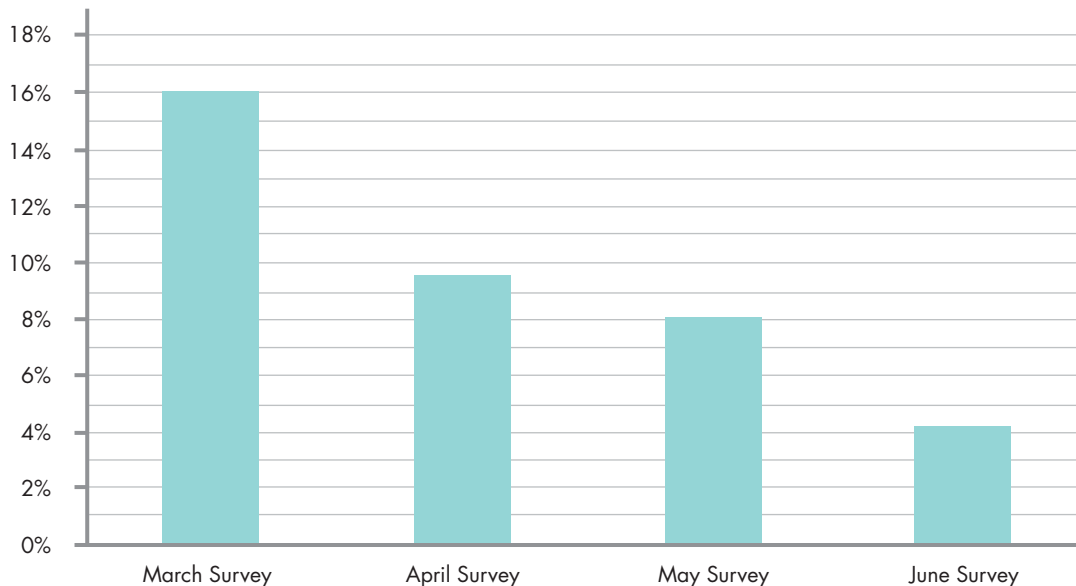
Business confidence shows signs of faltering

The second FSB 'Voice of Small Business Index' suggests that business confidence has faltered in the second quarter. This strengthens the argument that a strong economic recovery is not guaranteed in the current climate, and suggests an acknowledgement from businesses that there remain several important downside risks to growth. These include public sector spending cuts in the UK and eurozone, and continued constraints on bank lending.

While the March FSB Small Business Survey showed a net improvement in expectations for business prospects of 16% for the total sample, by June this had diminished to just over 4%. As figure 1 shows, net improvement in prospects has been on a downward path since March. Part of this trend decline may be attributable to the bad weather and VAT rise in January, which would have made the three months that preceded the March survey particularly

unfavourable to businesses. However, this would not explain the trend decline between April and June, during which confidence in the economic recovery has clearly worsened as the scale of the public deficit and the steps needed to reduce it became clearer.

Figure 1: Net improvement in small business prospects in three months time – monthly responses



Source: FSB-ICM 'Voice of Small Business' Panel Survey (March - June 2010)

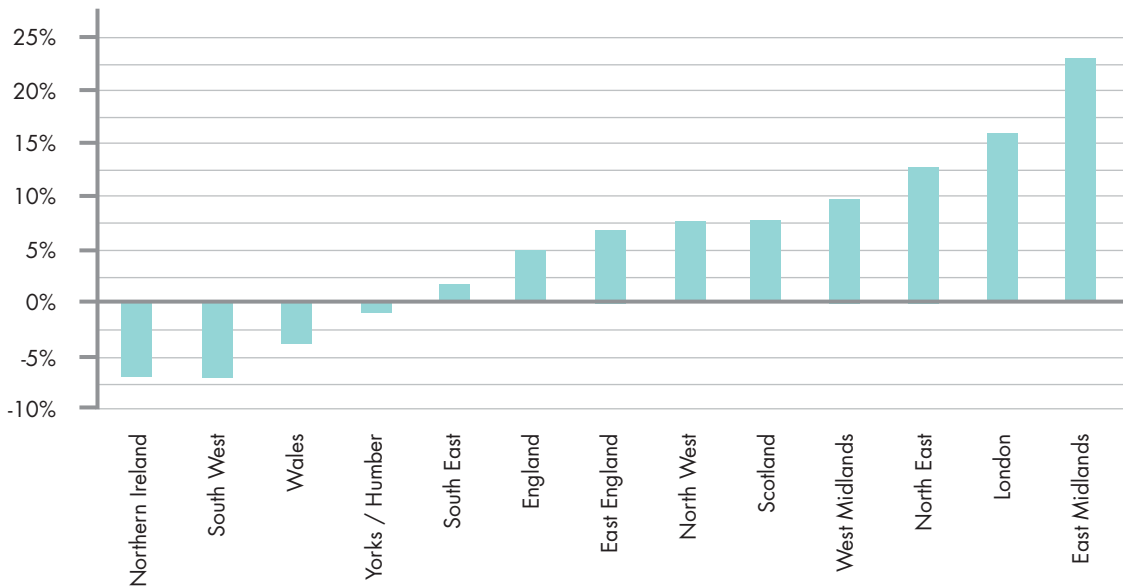
Figure 1 Net improvement is defined as the percentage point difference between the number of businesses who three months will improve, and those who feel that prospects will be worse.

Business confidence strongest in East Midlands and London

The FSB 'Voice of Small Business Index' shows considerable variation in small business views on economic prospects over the next three months. The strongest sentiment on business prospects over the next three months is in the East Midlands and London. A net balance of 23% of businesses in the East Midlands expect the prospects for their business to improve over the period compared with the previous quarter, while a net balance of 16% of small businesses

in London expected improvement as shown in figure 2. In contrast, businesses in Northern Ireland, South West England, Wales and Yorkshire and the Humber all expected business prospects to worsen over the next three months.

Figure 2: Net improvement in small business prospects in three months time – regional variation



Source: FSB-ICM 'Voice of Small Business' Panel Survey (June 2010)²

² Figure 2 Net improvement is defined as the percentage point difference between the number of businesses who feel that prospects over the next three months will improve, and those who feel that prospects will be worse.

Small business revenue growth expected to be weaker

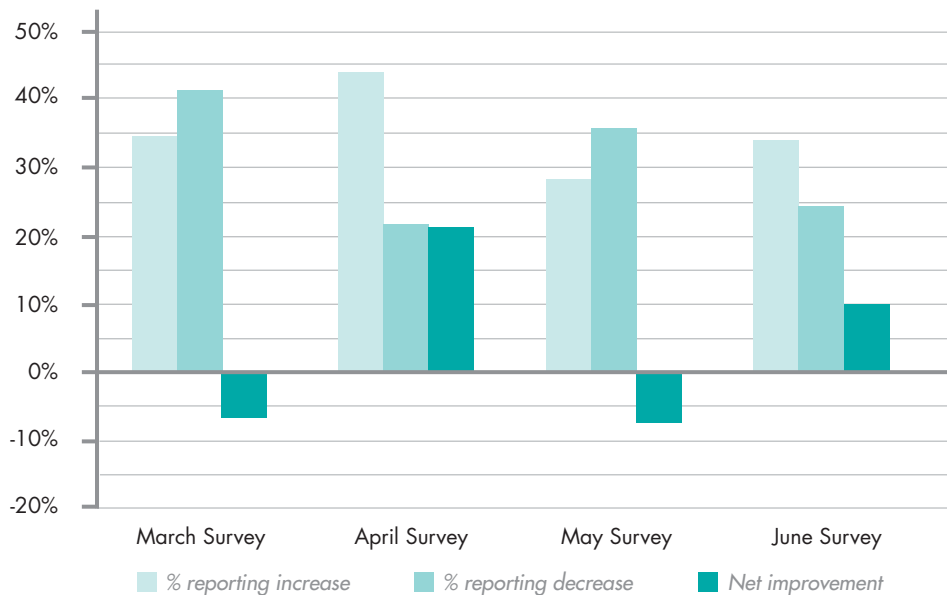
The FSB 'Voice of Small Business Index' suggests that business conditions remain tough, with a marginal deterioration in net sales revenue growth in May compared with March. The question: "Ignoring any normal seasonal variations at this time of the year, how much have the revenues/sales of your business changed over the last three months?" was asked in both the March and May FSB surveys, allowing us to make some comparison over time.

A net 7.6% of small businesses in the May survey reported a decline in revenues in the three months preceding May. This was slightly higher than that reported in March (7.2%). As figure 3 shows, the net worsening in revenue growth is attributable to a decline in the proportion of businesses reporting an increase in revenues in May, rather than an increase in the proportion of businesses reporting a decline in revenues. Indeed, the proportion of businesses reporting

a decline in revenues fell from 41.8% to 36.1%. This implies that growth has flattened off over the three months and while declines in revenue that one would expect in a double-dip recession scenario have so far been avoided, growth appears to be levelling off.

Firms were still optimistic that sales would continue to grow in the three months after May, with a net 9.8% of businesses expecting an increase in revenues over the time period. However, this is significantly lower than in the March survey, when a net 22% of businesses expecting sales to increase in the following three months. The key change has been a reduction in the share of firms expecting further growth and a small increase in those expecting declines. As such, there has been an increase in businesses expecting revenues to remain steady – the levelling off in the UK economy's recovery that has been feared.

Figure 3: Small business revenue growth



Source: FSB-ICM 'Voice of Small Business' Panel Survey (March & May 2010)³

Figure 3 Question asked: "Ignoring any normal seasonal variations at this time of the year, how much have the revenues/sales of your business changed over the last three months?"

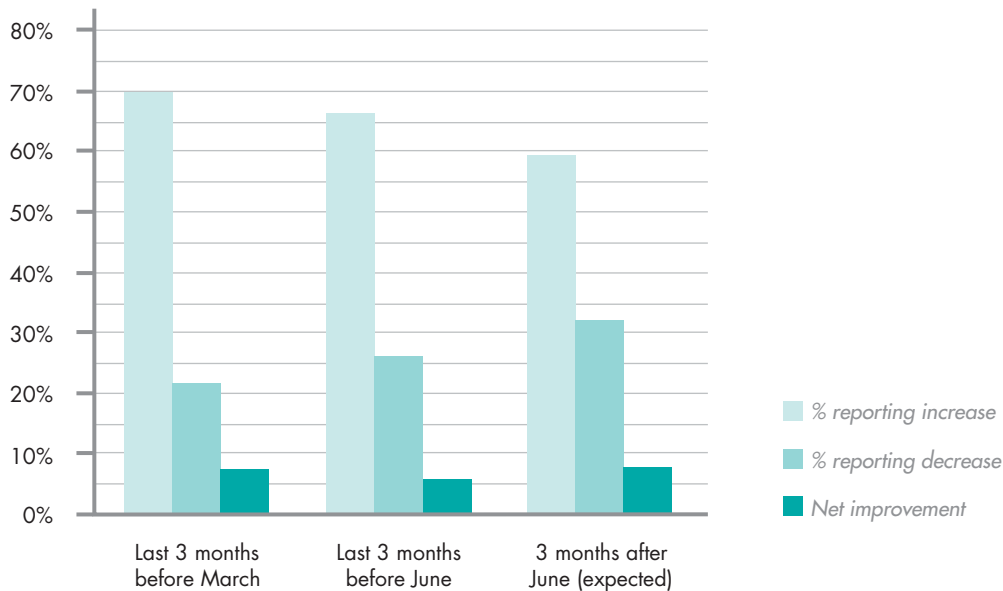
UK economy still running below capacity – but expectations for the future are (slightly) more optimistic

The FSB 'Voice of Small Business Index' continues to show that the majority of businesses are running below capacity, though the number has declined slightly from 70.5% to 66.6%. Hence, there remains substantial spare capacity in the UK economy, although there has been a steady (5.6 % point) increase in the share of businesses running at capacity as the economy continued to grow. Three in five

(59.7%) of businesses expect to be operating below capacity in the three months after June, and the number of businesses at capacity and above capacity is expected to increase as the UK economy steadily recovers. This indicator will need to be closely watched in the months ahead as questions remain about how much of the loss in output through this recession has been permanent and what the UK's

productive potential now is. The capacity indicator should provide key insights into both the extent of the recovery and inflationary pressures.

Figure 4: Share of small businesses running above, at or below capacity in the UK



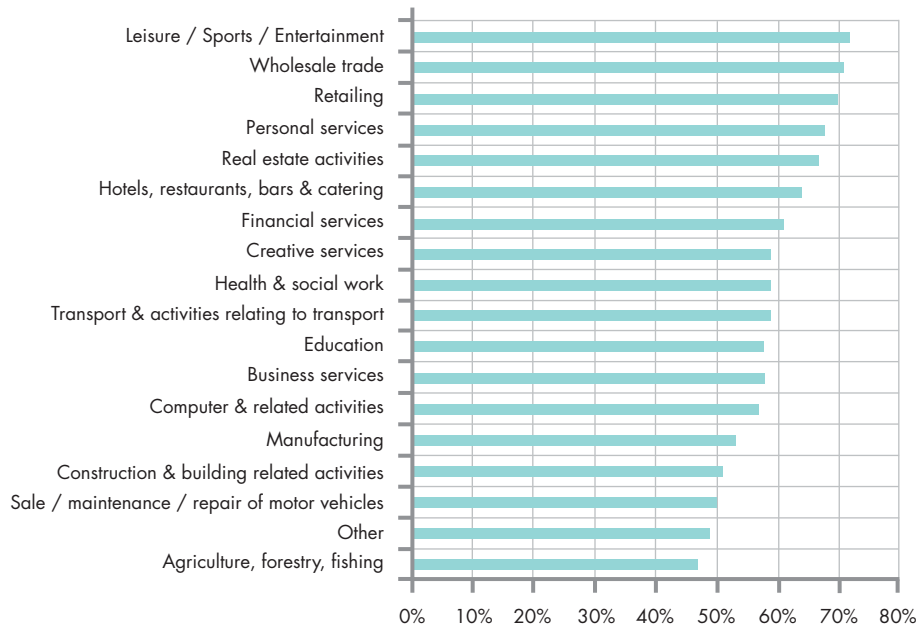
Source: FSB-ICM 'Voice of Small Business' Panel Survey (March & June 2010)⁴

Figure 4 Question asked: "Over the last three months, has your business been running at capacity or above or below capacity? Over the next three months, do you expect your business to be running at capacity or above or below capacity?"

For the FSB 'Voice of Small Business Index' we have also considered the sector and regional breakdown of firms working under-capacity. As figure 5 shows, there appears to be a service/manufacturing/industry split in under capacity, with the service sectors reporting the greatest level. Over 72% of businesses in the leisure, sports and entertainment sector expect to be below capacity in the next three months, suggesting that consumer demand remains relatively

constrained amid tight lending conditions and weak growth in real disposable income.

Figure 5: Small businesses expecting to be below capacity over the three months after June, by sector



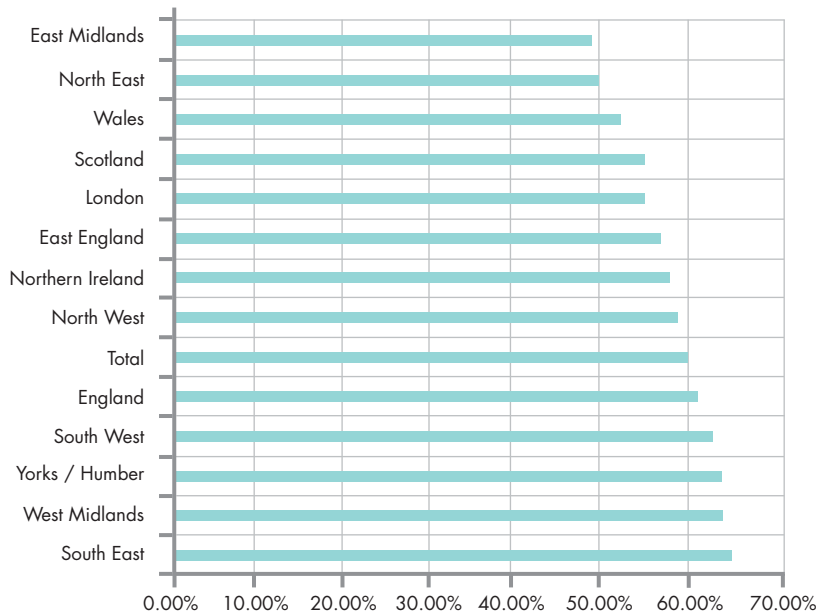
Source: FSB-ICM 'Voice of Small Business' Panel Survey (June 2010)⁵

Figure 5 Question asked: "Over the last three months, has your business been running at capacity or above or below capacity? Over the next three months, do you expect your business to be running at capacity or above or below capacity?"

Similarly, the FSB Small Business Survey suggests significant regional difference in under capacity. While 51% of East Midlands small businesses are expecting to operate at or above capacity, only 36% of South East firms are doing so. This may be down to two things. Firstly, services seem to be performing less well than manufacturing at present, and given that services are heavily concentrated in the South East (particularly business and financial services), this could

lead to the regional disparity described. Secondly, London and the South East have, and remain, the economic powerhouses of the UK, and the capacity of businesses in these regions prior to the economic downturn would have been significantly greater. Consequently, the amount of excess capacity in these businesses in the current low growth climate is likely to be more so than in other regions where pre-recession capacity was more limited.

Figure 6: Small businesses expecting to be below capacity over the three months after June, by region



Source: FSB-ICM 'Voice of Small Business' Panel Survey (June 2010)⁶

Figure 6 Question asked: "Over the last three months, has your business been running at capacity or above or below capacity? Over the next three months, do you expect your business to be running at capacity or above or below capacity?"

Methodology

This report is based on the June 2010 FSB-ICM 'Voice of Small Business' Panel survey of FSB members. All panel members (4,483) were invited to take part in an online survey. Reminders were sent to all non-respondents. 1,216 responses were received, a response rate of 27%. 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-ICM 'Voice of Small Business' panel surveys.



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