SBI Q4 2017

Small business confidence falls into negative territory for only the second time in five years

Confidence falls to level not seen since aftermath of EU referendum

Record number of entrepreneurs looking for an exit

1 in 7 Planning to downsize, close or hand on business

Operating expenditure at highest in five years

73% Report rise in costs of doing business

Exports remain strong

77% Say international sales are stable or increasing

Main causes of rising business costs

- Labour costs: 40%
- Utilities: 35%
- Inputs: 33%
- Fuel: 29%
- Currency weakness: 26%
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Confidence among small businesses has continued to decline and is now in negative territory for the first time since the referendum result last summer – sitting at -2.5. Continuing cost pressures and wider economic uncertainty has likely contributed to this fall. However, confidence has declined in every quarter in 2017 - from a high in Q1 2017 of +20.0 to the current level. This suggests that declining confidence cannot simply be attributed to uncertainty about the likely form that Brexit will take, nor changes in the domestic policy agenda. Consumer spending is clearly being squeezed owing to a sustained increase in inflation outpacing wage growth. Business costs are rising due to increased prices, utilities, auto-enrolment and labour costs as well as the continued impact of exchange rates, which combine to form severe cost pressure.

Operating costs continue to rise, with a net balance of 67.7% of firms reporting an increase compared to a year ago. This figure is the highest it has been in over five years, reflecting both a weak pound and rising inflation. Profitability has also fallen, likely reflecting the impact of increased costs.

Growing numbers of businesses also report they are likely to sell, close or downsize their business, with 14.6% considering one of these options. This figure is at an all-time high, breaking the previous record set in the last quarter. For the first time, one in seven existing small business owners could be looking for the exit.

With an Autumn Budget that was positive for UK small businesses and an Industrial Strategy as a first step to tackling the UK’s low productivity, we expect the benefits of these to be reflected in the Q1 2018 survey results. Small businesses across the UK will also be pleased and relieved by the conclusion of the first phase of the negotiations with the EU27. Even so, there remain a number of structural challenges to the economy where we seek Government intervention through domestic policy, in the next phase of the Brexit negotiations, and in the EU while the UK remains a member.

With regards to domestic policy, the Government must continue to identify ways to reduce the costs of doing business. The commitment to tackle the ‘staircase tax’ is very welcome. Small firms that share more than one floor have been hit with huge increases in non-domestic rates bills due to loss of small business rates relief for split workspaces. These bills are backdated by 2-5 years. Intense work is needed to create a new piece of legislation and guide it through a House of Commons with no in-built majority for the Government. This will require a short, focused Bill and the building of proper cross-party support. We also need to see new life breathed into efforts to tackle poor payment practice across the economy, with a number of initiatives needing to be refreshed and intensified. They include corporate governance reforms, duty to report, and ensuring the small business commissioner is equipped and active with a focus on this issue.

In Brexit negotiations, small businesses want to see early agreement in 2018 of a time-limited transition period, to make sure that small businesses that trade with EU27 markets only have to undergo one set of rule changes, rather than two. The future trading relationship with the EU must keep any additional tariff and non-tariff barriers to an absolute minimum, while the pursuit of trade agreements with the EU or indeed other countries or trading blocs. It is crucial we see a dedicated small business chapter to protect the bespoke exporting and importing needs of the UK’s 5.7m smaller businesses. The impending withdrawal of EU funds (subject to any transitional period) will leave a significant hole in the budgets for regional economic development, so setting out a settlement which supports regional growth is critical. The Government also needs to bring development of the UK Shared Prosperity Fund forwards to support the ambition of the Industrial Strategy to create an economy that works for everyone.

In the current EU institutions, small businesses are keen to make sure that new rules governing the e-commerce trading infrastructure work for the smallest firms and upcoming changes to consumer law are introduced in a business-friendly way.

With the Office of Budget Responsibility predicting that growth and productivity will be lower than expected in the coming years, now is the time for the Government to take forward the measures announced at the Budget and as part of the Industrial Strategy, but also to take further proactive steps to support small businesses. After Small Business Saturday celebrated our 5.7 million small business owners last month, they need help and support from policymakers of all parties to continue as the engines of the UK economy and the lynchpins of our local communities.

Mike Cherry, National Chairman

Martin McTague, Policy Director
Often, the end of a calendar year is a time of reflection when individuals and businesses alike consider the year behind them and the one that lies ahead. The results of the latest FSB Small Business Index show that, for many small firms reflecting on their past and future prospects, the picture is far from cheerful.

The final three months of 2017 have seen confidence among small businesses deteriorate for the third consecutive quarter. Furthermore, at -2.5 the index reading is in negative territory for only the second time in five years.

Considering the state of the broader economy, the pessimism expressed by small firms is perhaps unsurprising. Uncertainty over the final terms of Brexit likely continues to act as a weight on confidence. Business investment grew just 0.2% quarter-on-quarter in Q3, below the 0.8% and 0.5% seen in the first and second quarters respectively. The consumer side of the economy is facing challenges of its own with inflation well above earnings growth and retail sales volumes contracting in October for the first time since early 2013.

The overall subdued picture masks significantly different performances across different sectors. In the third quarter of 2017, economic growth was driven by the services and production sectors, while the construction sector contracted, entering a technical recession. We expect the weak performance in the sector to continue given that the FSB Small Business Index shows that in Q4 2017 a net balance of 3% of small construction businesses were confident about their prospects in the coming three months. This compares to 6% a year ago.

A glimmer of hope for those small businesses that are lacking in confidence may come from the Chancellor’s Autumn Budget unveiled in late November. Many of the Government’s announcements aim to ease the various pressures facing the UK’s small firms. This included the announcement that the Chancellor had listened to FSB and would not expand the VAT regime to include 1.5 million more of our smallest firms in one of the most difficult to administer taxes that businesses face. One of the most significant announcements is the decision to uprate business rates according to the CPI rather than RPI from April 2018, two years earlier than planned. The Treasury estimates that the switch will save businesses £2.3 billion over the next five years. This was matched by the commitment to over-turn the staircase tax, a move that will be welcomed by thousands of firms facing sudden backdated increases in their business rates bills, but we now need to see legislation, and quickly.

Furthermore, the Chancellor announced that the investment limit for the Enterprise Investment Scheme, which provides incentives to investors via income tax relief and capital gains tax savings, will be doubled, a move that the Treasury claims will generate £7 billion in additional investment for innovative companies.

The Industrial Strategy that followed the Budget also included some indications of help to come. The small business review pledged in it must not exist simply because the Government is not sure what to do while it is clearer when it comes to mid-sized and large companies. The review should be pursued with urgency and vigour, and come out with meaningful policy change. In particular Government interventions to support ‘in firm’ adoption of innovation must be co-designed with small businesses if we are to genuinely tackle the productivity puzzle. Equally important is that the announced review of the UK’s export strategy has small businesses front and centre and does not fall into the trap of disproportionately focusing on mid and larger sized businesses.

While no set of policy announcements can alleviate all of the challenges facing small firms (the FSB survey shows that the domestic economy, consumer demand and appropriately skilled staff present the greatest barriers to growth), the combination of measures announced in the Budget should support small business performance and confidence in the coming quarters, at least to an extent.
FSB EXECUTIVE SUMMARY

Key findings this quarter:

• **Small business confidence falls to lowest level since last year’s EU referendum.** The FSB Small Business Index fell from +1.1 in Q3 2017 to -2.5 this quarter. This is only the second negative index reading in five years. Confidence declined in each quarter of 2017.

• **Confidence rebounds in London, but falls across most other regions.** Small business confidence in the capital has improved markedly in Q4 after the index fell to a near six-year-low last quarter. However, most other regions saw a deterioration in business confidence since the previous quarter. Small businesses in the North of England and Scotland are particularly pessimistic about the future.

• **Manufacturing confidence improves.** Confidence among small manufacturers improved in the fourth quarter, suggesting that the industry will make a positive contribution to overall economic growth in Q4. However, there was a steep decline in confidence among construction firms.

• **Operating costs increase at fastest rate in five and a half years.** Small businesses report a further substantial rise in operating costs in the fourth quarter with a large proportion of firms citing utilities, inputs and the exchange rate as main contributors to overall cost inflation.

• **Export performance remains strong.** The net balance of small businesses reporting an increase in exports over the past three months stands at 11.5% this quarter. Although this is up from 6.1% a year ago, it is the lowest reading in 2017. Nonetheless, small business export performance remains strong by historical standards.

• **Employment and wage growth slow further.** The net balance of small companies reporting increased headcounts stands at just 1.4% this quarter, down from 2.9% a year ago. At the same time, annual average small business wage growth was just 1.5%, down from 2.2% in the same quarter last year. That said, companies expect an acceleration in wage growth to 1.8% over the coming 12 months.

• **Increasing proportion of small businesses anticipate downsizing over the next 12 months.** The share of businesses expecting to downsize, close or hand on the business over the coming 12 months stands at 14.6% this quarter. This is up from 9.4% a year ago, and the largest share since data collection began in 2012.
UK MACROECONOMIC OVERVIEW

Real wages continue to fall

UK economic growth picked up slightly to 0.4% quarter-on-quarter in the third quarter of 2017. Although this is a marginal improvement on the rates seen during the first half of the year, GDP growth remains subdued, especially when compared to the general trend between 2013 and 2016. Growth was largely driven by the production and services sectors while construction fell into a technical recession.

The Office for Budget Responsibility (OBR) has also now revised down its growth and productivity forecasts for the next few years, meaning that the UK economy is now expected to grow at an even slower pace than previously anticipated.

Data from the Office for National Statistics (ONS) showed that retail sales fell for the first time in over four years in October, thereby suggesting that the acceleration in household consumption growth in the third quarter was just a temporary rebound after a particularly weak Q2. With inflation continuing to outstrip wage growth, real wages are still falling. The OBR believes that real wages will continue to decline in 2018, further reducing household consumption.

The Bank of England (BoE) raised its benchmark interest rate by 0.25 basis points in November as inflation remains comfortably above the BoE’s 2% target. It was the first increase in the Bank Rate in a decade. The Bank will continue its programme of quantitative easing and made it clear that any further rate rises in the short term will be limited and gradual.

Figure one: Bank of England Bank Rate and CPI inflation.
**Small Business Index**

Small business confidence falls to lowest level since the EU referendum

Business confidence among small firms deteriorated in the fourth quarter of 2017, thereby continuing a downward trend that started in Q2 2017. Confidence fell from +1.1 to -2.5, its lowest level since Q3 2016 when the unexpected EU referendum results had likely weighed on confidence. With the exception of Q3 2016, the figures in this quarter are the lowest in five years.

The UK economy grew at a quarterly rate of 0.4% in the third quarter of 2017, up slightly on the rates recorded during the first half of the year but well below levels seen over much of the past two years. While household consumption growth tripled, business investment continued to slow and stood at just 0.2% in Q3. By sector, services and production lifted the UK economy between July and September while construction entered a technical recession, meaning the sector has now contracted for two consecutive quarters.

Figure two: The FSB Small Business Index: small business confidence for the coming three months


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1. The Small Business Index is a weighted index of 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.
Figure three: Year-on-year change in the FSB Small Business Index.

Figure four: UK SBI against year-on-year UK GDP growth.
Source: ONS, FSB - Verve ‘Voice of Small Business’ Panel Survey.
REGIONAL SMALL BUSINESS INDICES

Confidence falls across many regions
Small business confidence has fallen and turned negative in most regions during Q4. The North East and the North West have seen some of the most dramatic shifts in confidence over the last three months.

Confidence remains in negative territory in Scotland for the eighth consecutive quarter with the regional index falling to a one-year low. Confidence in Scotland improved earlier this year when official data showed that the Scottish economy grew at a quarterly rate of 0.6%. However, the Q4 confidence figures suggest that Scotland’s GDP growth is unlikely to have significantly accelerated from the 0.1% recorded in the second quarter of the year. Production and construction were pockets of particular weakness in the latest Scottish GDP figures. In the 2017 Autumn Budget, the Chancellor allocated £2 billion for the Scottish government which will hopefully provide a boost to the Scottish economy in the coming years.

There has been a rebound in confidence in London. Last quarter, confidence in the capital fell to its lowest level in almost six years which was likely a result of heightened uncertainty with regards to London’s banking sector after some of the largest banks had announced they would move at least some staff to mainland Europe. However, with the service sector continuing to grow, and with the Milken Institute recently crowning London as Europe’s best-performing city, it is not surprising that confidence in the capital has picked-up again.

Figure five: FSB Small Business Index – regional variation in small business confidence for the coming three months
SMALL BUSINESS SECTOR INDICES

Mixed confidence levels across sectors
CONFIDENCE AMONG MANUFACTURERS IMPROVES

Small business confidence in the manufacturing sector remains positive in the final quarter of 2017, suggesting that the industry will make a positive contribution to the overall UK economic performance at the end of the year. Improved global demand and a relatively weak pound should support UK exports in the coming months.

Meanwhile, there has been a particularly steep decline in confidence among construction firms, with confidence in this sector falling to its lowest level in five years. The construction sector entered a technical recession in the third quarter which is likely to have contributed to the overall decline in confidence. However, if the Government can help deliver 300,000 new homes as proposed in the Budget, building firms should start becoming more optimistic about their business prospects.

Figure six: FSB Small Business Index by sector – small business confidence for the coming three months.
FINANCIAL PERFORMANCE

Profitability declines
PROFITS FALL FURTHER

A net balance of 8.9% of small businesses report that average gross profits declined during the past three months, following fairly stable profit levels across the small business community in the previous quarter. The net balance of firms recording a fall in profits was the largest since the middle of 2013 with higher input costs continuing to put pressure on profits. Latest data from the ONS showed that the price for imported metals was up 12.3% in the year to October 2017, highlighting how the weakness of the pound has led to rising prices for imported goods and services.

Over the next three months, a net balance of 4.0% of small business expect profits to decline further. Political uncertainty is likely to result in further exchange rate volatility which could put further pressure on the pound and thereby continue putting upward pressure on import costs. Moreover, the Chancellor announced an increase in the National Living Wage by 33p an hour for workers aged over 25, potentially creating a further squeeze on profit margins.

Figure seven: Small business gross profits, net percentage balance – proportion reporting increase less proportion reporting decrease.
EXPORTS

Exporting continues to expand
This quarter, the net balance of small businesses reporting an increase in exports over the past three months stands at 11.5%. Although this is up from 6.1% a year ago, it is the lowest reading in 2017. However, this is still higher than any other reading before Q3 2016, with the exception of Q3 2013 when the balance also stood at 11.5%. Data released by the ONS shows that the UK’s goods and services trade deficit widened in the three months to September, largely as a result of an increase in goods imports. Looking ahead, a net balance of 18.8% of small businesses expect exports to increase over the next three months.

Although a relatively weak pound and an improving global economic environment should support UK exports, the Office for Budget Responsibility (OBR) predicts that the negotiation of new trading arrangements will slow the pace of import and export growth over the ten years following the EU referendum.

Figure eight: Changes in value of exports – previous three months and expectations for coming three months; net percentage balance, proportion reporting increase less proportion reporting decrease.
COSTS AND INFLATION

Costs continue to increase
LARGER SHARE OF BUSINESSES REPORT INCREASE IN OPERATING COSTS

This quarter, a net balance of 67.7% of small businesses report an increase in operating costs over the past three months compared with the same period a year ago. This is up from 56.6% a year ago and the highest net balance in five and a half years.

Four in ten companies cite labour bills as a main cause for rising business costs, while around one in three firms see utilities (34.9%) and inputs (32.8%) as main contributors to overall cost inflation, with the exchange rate specifically mentioned by 26.4% of small businesses. Despite a large proportion of businesses commenting that utility bills and inputs exerted upward pressure on business costs, recent data from the ONS showed that input price inflation, which measures all materials and fuels purchased by businesses, slowed to 4.6% in the year to October 2017. This is down considerably from 19.9% at the beginning of the year.

Figure nine: Small businesses reporting an increase in overall cost of operation over past three months, compared with the same period a year ago; net percentage balance.
Figure 10: Main causes for changing business costs (firms may give multiple answers).
CAPACITY

More businesses operate below capacity
SPARE CAPACITY RISES

The latest survey results highlight a growing share of small businesses operating below capacity this quarter. A net balance of 50.5% of small businesses report operating below capacity, up from 44.2% recorded a year ago and the highest figure recorded since Q2 2016. However, spare capacity is likely to fall slightly over the next three months, with 47.2% of firms expecting to be running below capacity.

The OBR wrote in its economic and fiscal outlook that the UK economy operated slightly below potential in the second quarter of 2017 and that there was more spare capacity than the OBR had anticipated in its March forecast. With the latest data suggesting that a relatively large proportion of small businesses continue to operate below capacity, and the BoE having recently raised interest rates for the first time in a decade, a further change to monetary policy seems unlikely.

Figure 11: Net percentage balance of businesses running below capacity: proportion below capacity less proportion above capacity.
EMPLOYMENT

Employment growth slows
FURTHER SLOWING IN EMPLOYMENT GROWTH

This quarter, a net balance of 1.4% of small businesses report that they have raised their workforce numbers over the past three months. This is down from 2.9% a year ago and the lowest reading since Q2 2016 when small businesses reported a decline in employment.

Data released by the ONS shows that the UK unemployment rate stood at 4.3% in the three months to September – the lowest level in over four decades. However, the share of people aged 16-64 in work continued to fall and stood at 75.0%. This is still high by historical standards, but down from 75.3% in the three months to July, with employment falling by 14,000. The decreasing employment rate, and the first quarter-on-quarter drop in total employment figures since 2016, could be a sign that the UK labour market has passed its peak and may explain why the net balance of small businesses intending to raise their staff levels over the next three months stands at just 2.9%.

Figure 12: Net percentage balance change in number of people employed – proportion reporting increase less proportion reporting decrease.
SMALL BUSINESS WAGE GROWTH SLOWS FURTHER

This quarter, annual average small business wage growth has slowed to 1.5%, down from 2.2% a year ago. Wage growth slowed for the fourth consecutive quarter and was the weakest since Q1 2015.

The findings from the latest survey are mirrored by data from the ONS which shows that average weekly earnings for employees rose at an annual rate of just 2.2% in the three months to September. This was little changed from the rates seen throughout this year so far, and well below the levels in the middle of 2015 when wages were growing at an annual rate of over 3%.

Although small businesses are confident that wage growth will pick up somewhat over the next 12 months, the rate of increase is expected to remain below the 2% mark. With consumer price inflation outstripping wage growth, the squeeze on household budgets is therefore set to continue. The OBR projects consumer price inflation to remain above average earnings growth in 2018.

Figure 13: Average salary increase awarded, this quarter versus a year before.
GROWTH ASPIRATIONS AND CHALLENGES

Record numbers expect to downsize or close
INCREASING SHARE OF SMALL BUSINESSES ARE PLANNING TO DOWNSIZE

There is a growing number of small business owners planning to downsize, close or hand on their firm in the coming 12 months. The share of these firms stands at 14.6% in Q4 2017, up from 13.5% in Q3 2017 and the highest since comparable data first became available in Q1 2012. The proportion of businesses expecting to grow over the next 12 months dipped slightly. Nonetheless, more than half of small businesses predict an expansion.

The share of business owners expecting to downsize, close or hand on the business has increased steadily since Q4 2016 when less than one in ten firms was pessimistic about the future. The domestic economy remains a main worry with almost two thirds of small businesses citing it as a major growth barrier. GDP growth was disappointingly weak over the first half of 2017, growing at quarterly rates of just 0.2% and 0.3% in Q1 and Q2 respectively.

Figure 14: Growth aspirations for next 12 months.
DOMESTIC ECONOMY REMAINS MAIN BARRIER TO GROWTH ASPIRATIONS

The domestic economy remains the primary barrier to growth aspirations this quarter, although the share of small businesses citing it has fallen slightly to 55.0%, from 56.7% a year ago. This is still higher than the figures recorded between 2014 and 2015 when the UK economy grew at a much stronger rate than now. There is also a smaller share of firms mentioning consumer demand as a growth barrier. At 33.7%, the figure is down from 37.8% a year ago, but still indicative of businesses worrying about the decline in real incomes.

With average earnings growing at a relatively subdued rate, the share of companies expecting labour costs to be a barrier to growth aspirations stands at 20.8% this quarter, down from 23.8% a year ago. With global trade volumes growing strongly and world GDP growth expected to accelerate, the share of small businesses seeing the foreign economy as a major barrier to growth stands at just 11.8%, down from 15.4% a year ago.

Figure 15: Potential barriers to achieving growth aspirations – multiple answers possible.
Appetite for credit falls
This quarter, the proportion of small businesses successful in their credit applications stands at 66%, up slightly from 62% a year ago.

The proportion of businesses being offered a rate of up to 4% has risen from 29.1% in Q4 2016 to 38.5% this quarter. At the same time, the proportion of small businesses being offered a rate of above 11% has fallen from 12.6% to 4.0%. After the Bank of England raised interest rates in November for the first time in a decade, some businesses may face higher rates going forward.
Figure 17: Proportion of small businesses successful in their credit applications in the past three months. Source: FSB - Verve 'Voice of Small Business' Panel Survey.
This quarter, the FSB credit affordability index stands at -9.1, down from -7.6 in the same quarter last year. The proportion of small businesses reporting new credit to be very affordable almost halved since Q4 2016 and now stands at only 3.7%. Meanwhile, the FSB credit availability index improved since the previous quarter and reached a new peak.

Latest data on SME finance published by UK Finance for Q2 2017 showed that eight out of ten applications for bank finance were approved. However, with the actual number of applications down by 14% compared with the same quarter last year, the amount of new lending approved has fallen.

Figure 18: Indices of credit affordability / availability perceptions over time, a weighted net balance of those with negative responses subtracted from those with positive responses.
INVESTMENT AND PRODUCTIVITY

Little movement in investment intentions
INVESTMENT INTENTIONS LARGELY UNCHANGED

A slightly smaller proportion of small businesses expect capital investment to increase over the next 12 months. The respective net balance stands at 29.9% this quarter, little changed from the 30.3% recorded in the same quarter last year.

Meanwhile, the proportion of small businesses anticipating a decrease in capital investment rose marginally from 13.2% in Q4 2016 to 13.6% this quarter.

Figure 19: % of small businesses expecting to increase and decrease capital investment over next 12 months, compared with the previous 12 months.
This report is based on the November 2017 research survey of FSB members carried out by Verve. All panel members (3,960) were invited to take part in an online survey. Reminders were sent to all non-respondents. 1,084 responses were received, a response rate of 25%. The data are weighted by regional gross value added to match the profile of small businesses across the UK. The survey was undertaken between 9 – 25 November 2017.
## SUMMARY DATA TABLE

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The Small Business Index weights strong responses (much improved or much deteriorated conditions) double and subtracts the weighted proportion of firms reporting deterioration in business prospects over the coming three months from the weighted proportion expecting an improvement.

The Employment and Revenue indicators are net percentage balances, with the proportion of firms reporting a decrease subtracted from the proportion reporting an increase.

Responses are also weighted according to regional gross value added.