

Q1

FSB VOICE OF SMALL BUSINESS INDEX

QUARTER 1, 2016

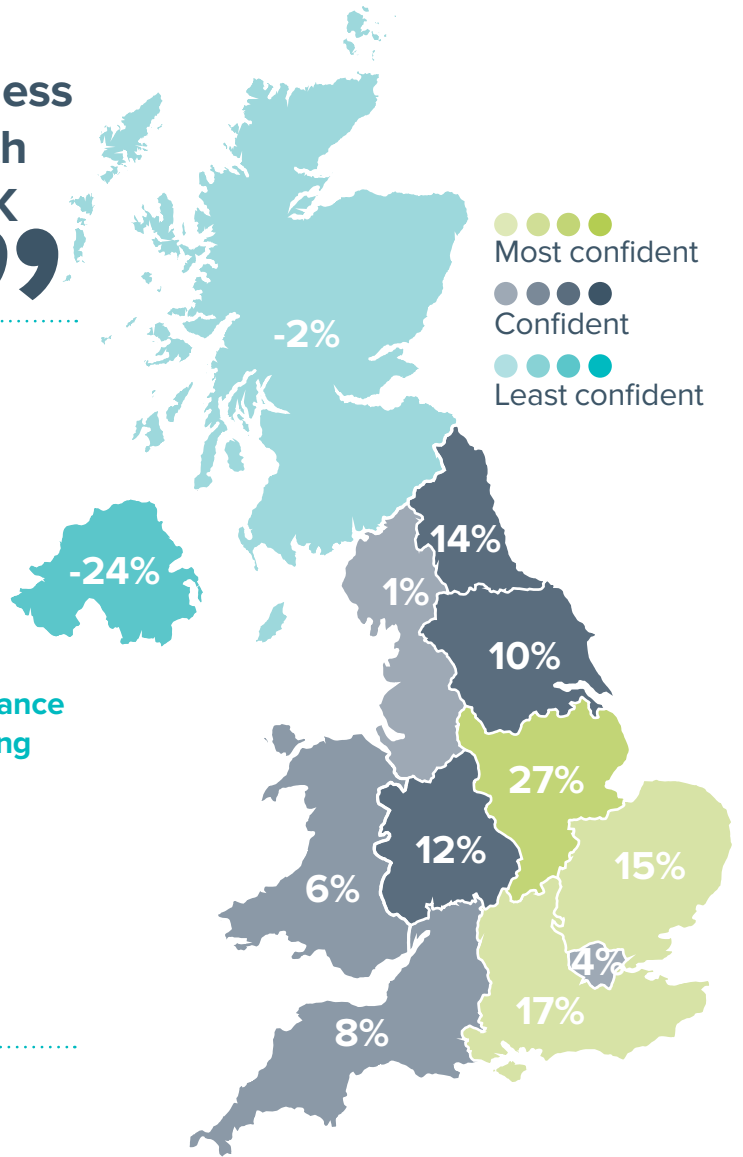
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SMALL BUSINESS CONFIDENCE



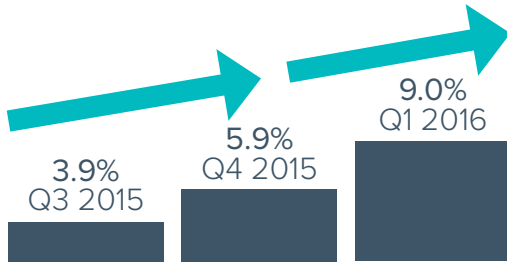
Small business confidence, business revenue and profitability growth have all declined across the UK



Improving credit



1 in 10 small businesses applied for alternative finance including peer-to-peer lending and crowdfunding

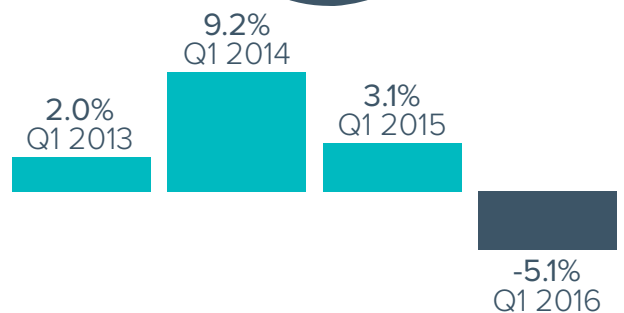


Obstacles to growth

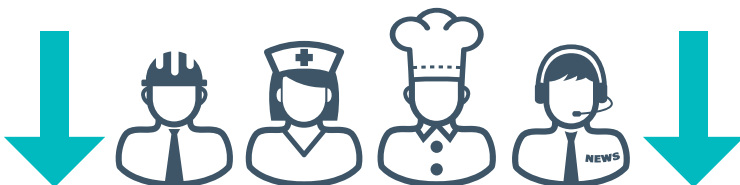


1 in 4 view tax and regulatory burdens as a barrier

Exports post weakest performance since 2012



First fall in job creation since Q2 2013



FSB NATIONAL VICE CHAIRMAN

Concerns about both the national and global economy - combined with incoming policy changes which could negatively affect smaller businesses - have resulted in a worrying drop in confidence this quarter.

The introduction of pensions auto-enrolment, the National Living Wage and changes to the tax treatment of dividends all pose challenges to small business owners. Concerns about their collective impact appear to be leading to small businesses scaling back hiring and investment intentions. The increase in the number of firms expecting to downsize or close in the next quarter - taken alongside the sharpest dip since 2012 in the number of firms expecting to grow - also gives a clear indication of the impact the difficult macro-economic and regulatory picture is having across the country.

This quarter also represents the first negative quarter for job creation since 2013, with labour intensive sectors such as accommodation and food services being most likely to report a drop in confidence, reflecting the rising cost of employment for many smaller businesses. Uprating the Employment Allowance from the current £2,000 level to £3,000 in April should help mitigate some of the rising costs of employment, but is not high enough to cover the increase in full.

Small businesses have also reported that future plans to introduce mandatory quarterly digital tax reporting will prove challenging. This change would represent a significant increase in the regulatory burden on smaller businesses. The increase in the number of businesses reporting that regulation is a barrier to growth is an illustration of this point. While FSB supports the digitalisation of Government services, any change must be voluntary, phased in gradually, and ensure that all users have both the skills and ability to use these new systems.

The drop in confidence among smaller businesses has been most notable in London and the East of England, but all regions of the UK have seen declines. London based businesses have likely been negatively affected by concerns about the strength of the global economy. Scotland reports negative sentiment in this quarter, potentially reflecting the impact on local businesses of falling oil prices.

The first fall in export value since 2012 is particularly worrying news. Much of this shift can be attributed to the fall in growth rates across both emerging and developed economies - the challenging international climate makes it even more important that the Government continues to support British exporters. We would also expect that the falling value of the pound in recent months will help exporters in the future.

The increase in the level of spare capacity reported by small firms suggests that interest rate rises are unlikely in the near-term, which will help keep operating costs low for smaller businesses. The increase in spare capacity does however reverse the trend over the past few years, and demonstrates weak consumer demand

as well as a continuation of sluggish productivity growth in the near-term.

Despite this negative picture, there are several positive data points to highlight. Access to finance has been a key priority for FSB for many years, and with a record percentage of smaller businesses accessing credit in the past quarter, it appears significant progress is now being made. Alternative financing models, such as peer-to-peer lending and crowdfunding are becoming increasingly attractive to smaller businesses, with almost 1 in 10 using these new and innovative products. This figure has risen from just 3.9 percent two quarters ago. The share of small businesses using asset-based financing has also increased in recent quarters. As the awareness and availability of these products continues to increase, we can expect to see these trends continue.

Fuel costs remain low, providing a lifeline for smaller businesses - particularly those in rural communities which are most affected by changes in fuel prices. The removal of the fuel duty escalator - combined with falling oil prices - has been a welcome support for smaller businesses.

The resilience of the small business community is also demonstrated in this survey. Despite the headwinds facing SMEs over the next quarter, small businesses report that they would like to export more, and to increase employment, profitability and revenue in the next quarter. A Budget which places no further burdens on British businesses would help make these aspirations a reality.

It is crucially important then that the Government recognises the combined impact of upcoming regulatory changes on small business sentiment. On top of this, small businesses are looking to the Government to support them with key policy reforms. When the Chancellor recently spoke at FSB's Policy Conference, he pledged to back small businesses - and now is the time to deliver on this promise.

Fundamental reform of the business rates regime, simplification of the tax system and further investment in infrastructure will help demonstrate this Government's commitment to smaller businesses. This document was written before the 2016 Budget Statement, so does not reflect any announcements which may have been made. Regardless, FSB will continue to make the case to Government that these reforms, and our other key policy priorities, are prioritised and delivered.

Amid challenging economic and regulatory threats, small businesses remain the engine of the British economy. Despite the challenging outlook as highlighted by the latest SBI figures, FSB will continue to serve as a voice for smaller businesses to the Government and all political parties. With the continuing support of our members, we can work with Government to create the right business and policy conditions to help smaller businesses grow.



Sandra Dexter,
FSB National
Vice Chairman

ECONOMIST'S VIEW

This quarter's FSB Small Business Index (SBI) suggests that the UK could be in for a challenging time in 2016, after enjoying two years of fairly solid economic growth in 2014 and 2015. Small business confidence stands at its lowest level since the start of 2013, and a range of financial performance indicators such as turnover and profit growth have also weakened.

Critically, the share of small businesses operating below capacity has increased significantly this quarter, which has major implications for the future path of monetary policy in the UK. The Bank of England has made clear on a number of occasions that the scale and pace of interest rate rises will be determined by the extent to which 'slack' in the economy is diminishing. The latest SBI suggests that an imminent rate rise is not warranted, with over half of small companies operating below capacity. We at Cebr do not believe that the Bank of England will raise rates until mid-2017 at the very earliest.

Small business investment intentions have continued to fall back this quarter, perhaps reflecting a high degree of economic uncertainty. Financial markets were volatile at the start of this year, as investors have become increasingly jittery about the state of the world economy. UK-specific data have been mixed, with a combination of solid data (e.g. falling unemployment) and weak data (e.g. on construction and trade). This is making it hard to accurately gauge the overall trajectory of the economy.

On the bright side, the availability and affordability of credit seems to be improving for small businesses so, when confidence starts to improve again, they should find it easier to undertake the investments that they wish to make. This quarter's report shows that small businesses are increasingly using alternative finance such as peer-to-peer lending, asset-based finance and crowdfunding – suggesting that they are using new channels to raise capital in a post-financial crisis world.

Overall, this quarter's SBI points to slower economic growth in 2016, with some significant hurdles over the coming quarters. Businesses believe that taxation and regulation have become more of an issue compared with a year ago – perhaps unsurprising given measures such as the National Living Wage and changes to the tax treatment of dividends which will come into effect in April. The Chancellor might need to introduce some new measures, either in the form of additional infrastructure spending or tax cuts, in order to bolster economic growth during a difficult time for both the UK and the global economy. Promoting growth should probably take priority over further austerity until the UK is back on a stronger footing.



Scott Corfe,
Director, Cebr

FSB EXECUTIVE SUMMARY

Key findings this quarter:

- **The Small Business Index has declined further this quarter.** Small business confidence has fallen to its lowest level since Q1 2013, amid a great degree of uncertainty over the strength of the UK and, more broadly, the global economy. Additional pressures being introduced by the Government, such as pensions auto-enrolment, the introduction of the National Living Wage and changes to the tax treatment of dividends are likely to be having an impact on business confidence in this quarter.
- **Small business confidence has declined in every region of the UK compared with a year ago.** Falls in confidence were particularly marked in London and the East of England. Falling confidence in London in particular can likely be attributed to concerns about the global economy.
- **The number of businesses expecting to see business performance decline has increased to 34.8%.** This has been the main driver for the decline in overall business confidence.
- **Confidence stands in negative territory for Scotland and Northern Ireland this quarter.** Scotland's economy has been significantly impacted by declining oil prices, while Northern Ireland continues to struggle with a high dependence on public sector employment at a time of both job shedding and pay restraint in the sector.
- **Small business confidence declined across most sectors compared with a year ago in Q1 2016.** The largest point decline was seen in the accommodation and food services sector, followed by manufacturing. The largest increase in small business confidence was seen in the real estate sector, which posts the second highest level of confidence this quarter (after financial services).
- **This quarter represents the first negative quarter for job creation since 2013.**
- **Profitability has declined.** More small businesses report that profits have fallen rather than increased over the past three months. Profits have declined at a time of rising revenues - pointing to a squeeze on small business profit margins in early 2016.
- **Exports posted their weakest performance since our research records began at the start of 2012.** A net balance of 5.1% of businesses reported that export values declined over the past three months, with a weak global economy curbing demand for UK goods and services.
- **Investment intentions fell back this quarter.** A net balance of 18.5% of firms report that they anticipate increasing capital investment over the next 12 months. This is down from 24.9% at the same point a year ago and the lowest net balance since Q2 2013.
- **Spare capacity has increased significantly among small businesses.** A net balance of over half (56.8%) of small businesses reported operating below capacity over the past three months, the highest since Q1 2013. The net share of businesses operating below capacity is expected to decline to 47.5% over the next 12 months - still higher than that seen at the end of 2015.
- **Firms report improving credit conditions and are increasingly using alternative finance.** Just under one in ten (9.0%) of small businesses who applied for credit applied for peer-to-peer lending or crowdfunding, up from 3.9% in Q3 2015 and 5.9% in Q4 2015. The share of businesses applying for asset-based financing such as invoice finance has also increased since Q3 2015.

UK MACROECONOMIC OVERVIEW

A number of economic challenges in 2016 and beyond

Since the end of last year, the economic outlook has taken a turn for the worse; with financial markets falling based on the apparent weakness of the global economy and reduced commodity prices. Already, the decision of the US Federal Reserve to raise interest rates in December looks premature.

UK economic data have been mixed. Whilst there are some strong points - particularly consumer spending and services exports - there are also substantial weaknesses. The UK's goods trade deficit stood at a record level in 2015 and export-led growth is set to remain elusive given the gloomy global backdrop. Business confidence has also fallen back, which will curb investment intentions.

While a recession still looks unlikely, the UK's short-to-medium term economic outlook looks worse than at the end of 2015. Furthermore, there are significant bands of uncertainty around growth projections at present, with some substantial downside risks. A sharp and continued slowdown in China, Brazil and Russia, weakness in global stock markets and the prospect of another Eurozone crisis could all have an impact on the UK's own economic performance.

Given this, monetary policy is likely to remain loose, with the Bank of England likely to keep interest rates unchanged for the rest of the year.

The real concern for the UK is the lopsided nature of its economic growth profile. Growth is extremely reliant on the services sector and consumer spending, as opposed to construction, manufacturing, trade and investment. While consumer spending could offset underlying weaknesses in the economy this year, supported by low inflation and falling unemployment, the UK could find itself in a very vulnerable position should the outlook for households start to worsen. This could happen as soon as next year, when inflation is likely to rise from the current low levels.

Without broader economic growth, with a significant contribution from export and investment growth, the UK risks being stuck with sluggish growth beyond this year. The UK's poor productivity performance is particularly concerning. According to recently released figures from the Office for National Statistics (ONS), shown in Figure 1, the latest data shows a substantial 18 percentage point gap in productivity between the UK and the rest of the major G7 economies, in terms of GDP per hour worked. Unless the UK's productivity problems are addressed, it could find itself trapped in an environment of weak economic growth as well as sluggish rises in living standards for employees and business owners.

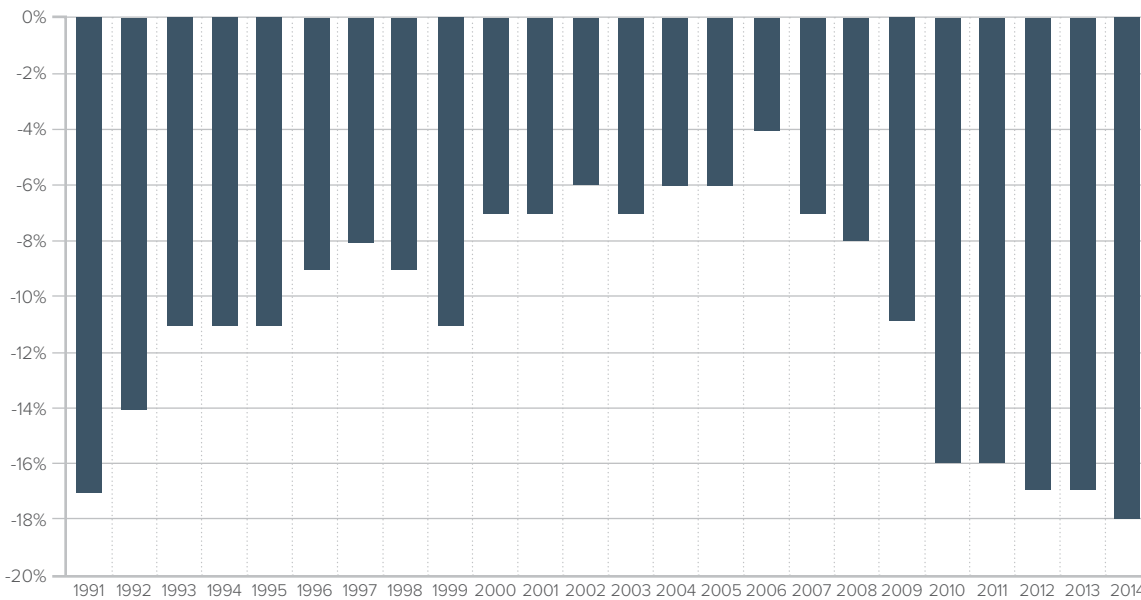


Figure 1: UK's productivity shortfall compared with the rest of the G7

Source: Office for National Statistics. Productivity refers to GDP per hour worked.

LATEST RESULTS

Business confidence stands at lowest level since Q1 2013

This quarter, the Small Business Index fell to 8.6, the lowest level since the first quarter of 2013 - a time when there were still huge doubts over the strength of the UK economy and many were discussing the prospect of a 'triple dip' recession. Confidence has been on a downward trend since the recent peak score of 37.9 was recorded in Q2 2015. Overall, confidence among smaller businesses is 20.1 percentage points lower than in Q1 2015. The current environment - with escalating costs to business, global economic weaknesses, policy uncertainty and an intensely competitive retail sector - appears to have had a discernible effect on the sentiment of small businesses in the UK.

The biggest driver of the sharp decline in confidence this quarter has been a significant increase in the proportion of firms reporting that they expect business performance to worsen over the next three months. This stands at 34.8%, up from 23.3% in Q4 2015. This increase largely came from small businesses moving from believing that prospects will "stay the same" to "worsening".

The Small Business Index is a leading indicator, as shown in Figure 4, and our latest results suggest that economic growth slowed significantly at the start of 2016.

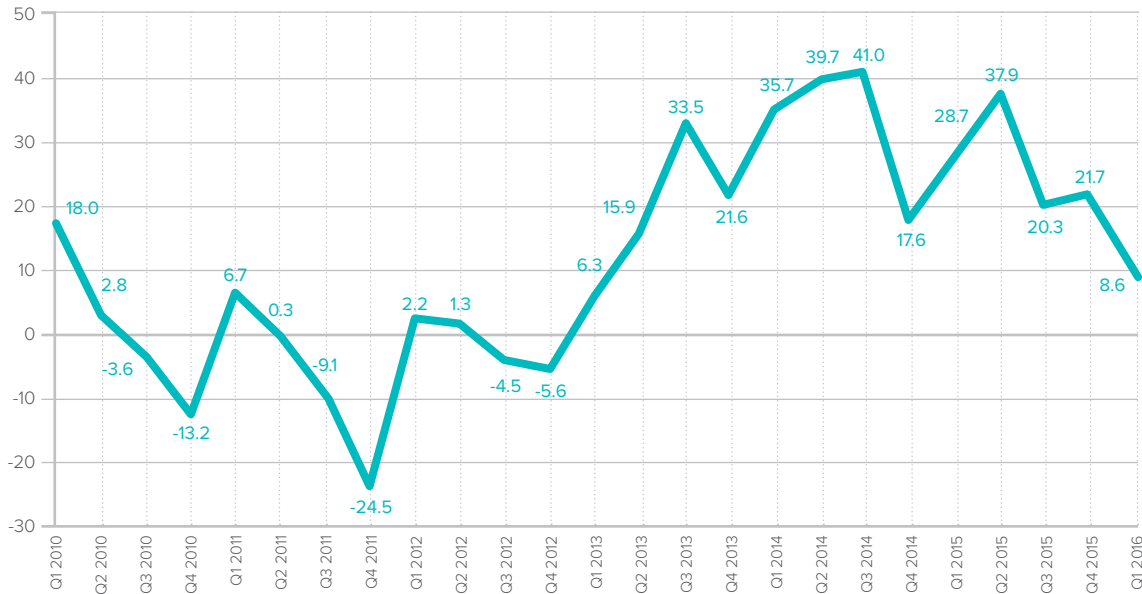


Figure 2: The FSB SBI¹: small business prospects over coming three months

Source: FSB - Verve 'Voice of Small Business' Panel Survey.

1. The FSB 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.

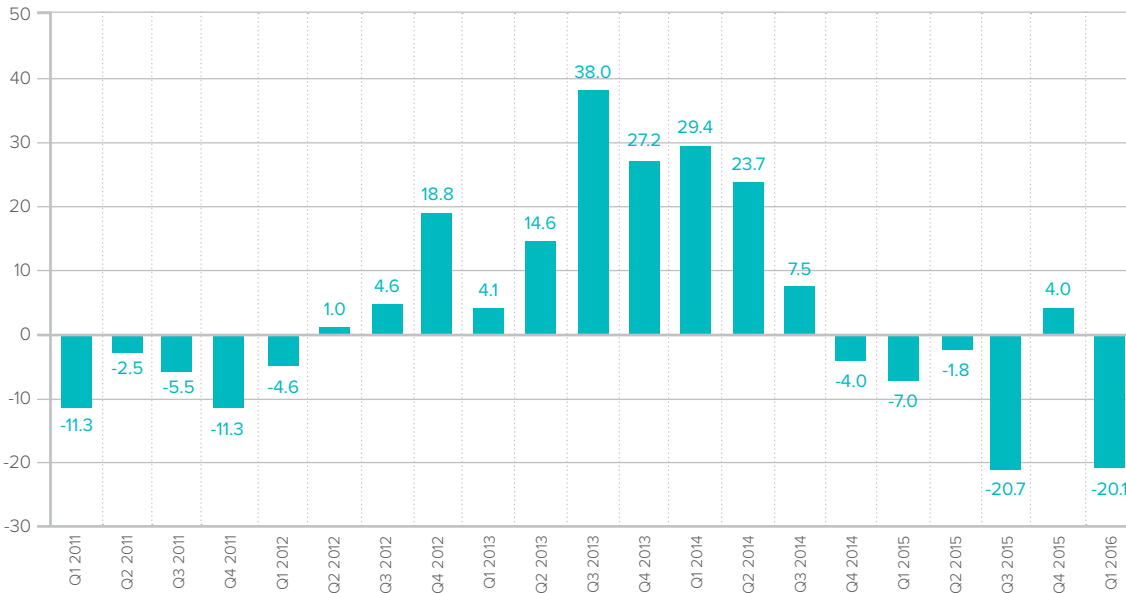


Figure 3:
Year-on-year change
in the FSB SBI

Source: FSB - Verve 'Voice of Small Business' Panel Survey



Figure 4:
FSB SBI against
year-on-year UK
GDP growth

■ Small Business Index (LHS) ■ Year-on-year GDP growth (RHS)

Source: FSB SBI, Office for National Statistics, Cebr analysis

REGIONAL SMALL BUSINESS INDICES

London and the East of England
have seen steep falls
in confidence

CONFIDENCE DECLINED IN EVERY PART OF THE UK COMPARED WITH A YEAR AGO

Small business optimism levels have fallen back year on year this quarter in every part of the UK, pointing to a slowdown across the entire country. The largest declines were seen in the East of England and London - two regions which have historically seen relatively solid economic performance. Confidence in the capital may have been particularly impacted by the deterioration in the global economy over the past year, given the international reach of many of London's services firms.

Confidence stands in negative territory for two regions this quarter - Scotland and Northern Ireland. Scotland's economy has been significantly impacted by the decline in global commodity prices, which has taken its toll on the country's oil industry. Northern Ireland continues to struggle with a high dependence

on public sector employment at a time of both job shedding and pay restraint in the sector. According to the ONS, over a quarter (25.7%) of workers in Northern Ireland were employed by the Government in September 2015, much higher than the UK average of 17.0%.² Furthermore, the recently announced factory closure by Bombardier is also likely to weigh down on confidence, hitting small firms in the supply chain.

Business confidence is highest in the East Midlands, the East of England and the South East this quarter, although confidence has again fallen in all three of these regions - with the East of England seeing a particularly steep decline.

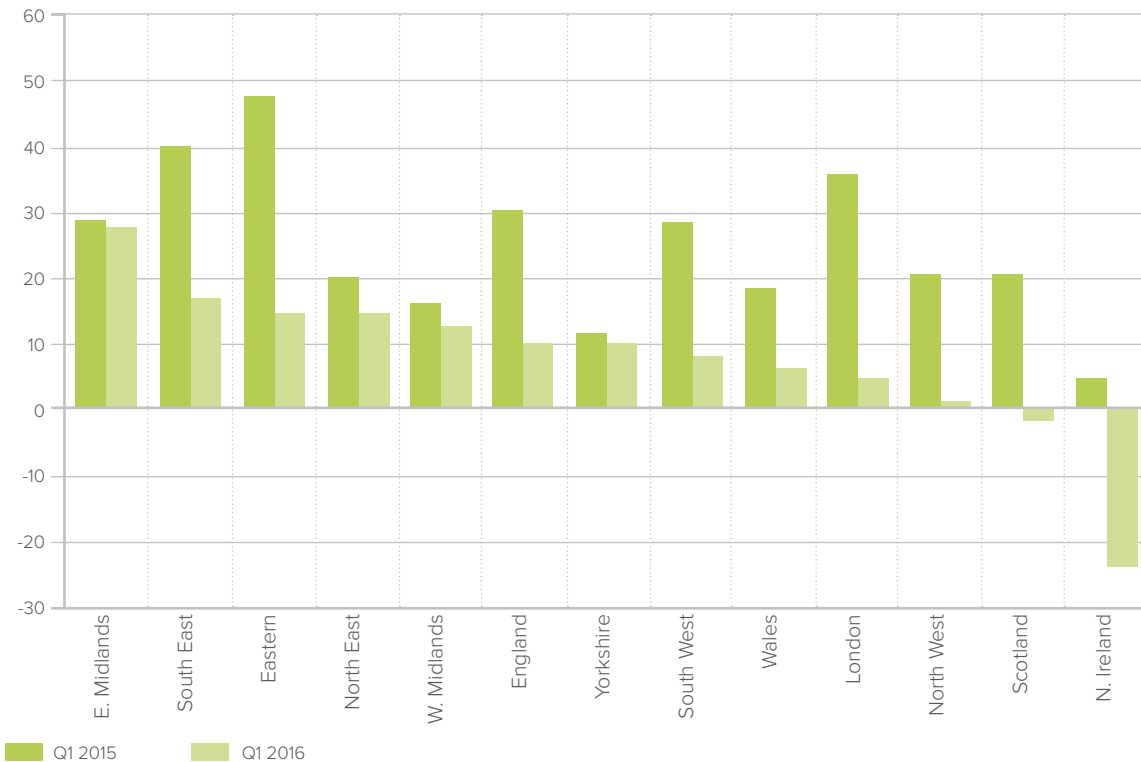


Figure 5: FSB SBI – regional variation in small business prospects over coming three months

Source: FSB - Verve 'Voice of Small Business' Panel Survey. Please note that we received limited responses from small businesses in Northern Ireland. As a result, the data on confidence in Northern Ireland is not necessarily representative of small business sentiment.

2. ONS, Public Sector Employment, September 2015. Available at <http://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/publicsectorpersonnel/bulletins/publicsectoremployment/september2015>

SMALL BUSINESS SECTOR INDICES

Confidence among
accommodation and food
services businesses has
fallen sharply

FINANCIAL SERVICES AND REAL ESTATE SECTORS ARE THE MOST CONFIDENT

Small business confidence declined across most sectors compared to a year ago. The largest decline was seen in the accommodation and food services sector, followed by manufacturing. Accommodation and food services businesses will be among the hardest hit by the National Living Wage when it comes into effect in April, and could see a significant erosion of company profit margins.

The manufacturing sector faces a difficult period as the outlook for global trade remains highly subdued, with demand for British goods exports struggling to grow. Data from the ONS showed that the value of goods exports fell by 2.8% in 2015,³ and 2016 looks set to be another difficult period for manufacturing exporters as the world economy continues to present a challenging outlook.

The largest increase in small business confidence was seen in the real estate sector, which posts the second highest level of confidence this quarter after financial services. Many of those in the sector have benefited from continued strong growth in UK house prices, something which is likely to continue for at least the first half of 2016 as the supply of homes on the market continues to lag demand. ONS data showed house prices rose by a further 6.7% in 2015, following 2014's substantial 10.0% increase.⁴

Despite a mildly positive environment for household incomes – with low inflation, real wage growth and falling unemployment – small business confidence in the wholesale & retail sector is in negative territory. This might reflect pervasive price competition in the sector which has squeezed profit margins, as well as the challenge of adapting to the forthcoming National Living Wage. Structural changes such as the continued shift to online retail have also impacted companies that have not yet adapted to competitive pressures resulting from the rise of new technologies.

3. ONS, UK Trade, December 2015. Available at <http://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/bulletins/uktrade/december2015>

4. ONS, House Price Index, December 2015. Available at <http://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/housepriceindex/december2015#datasets>

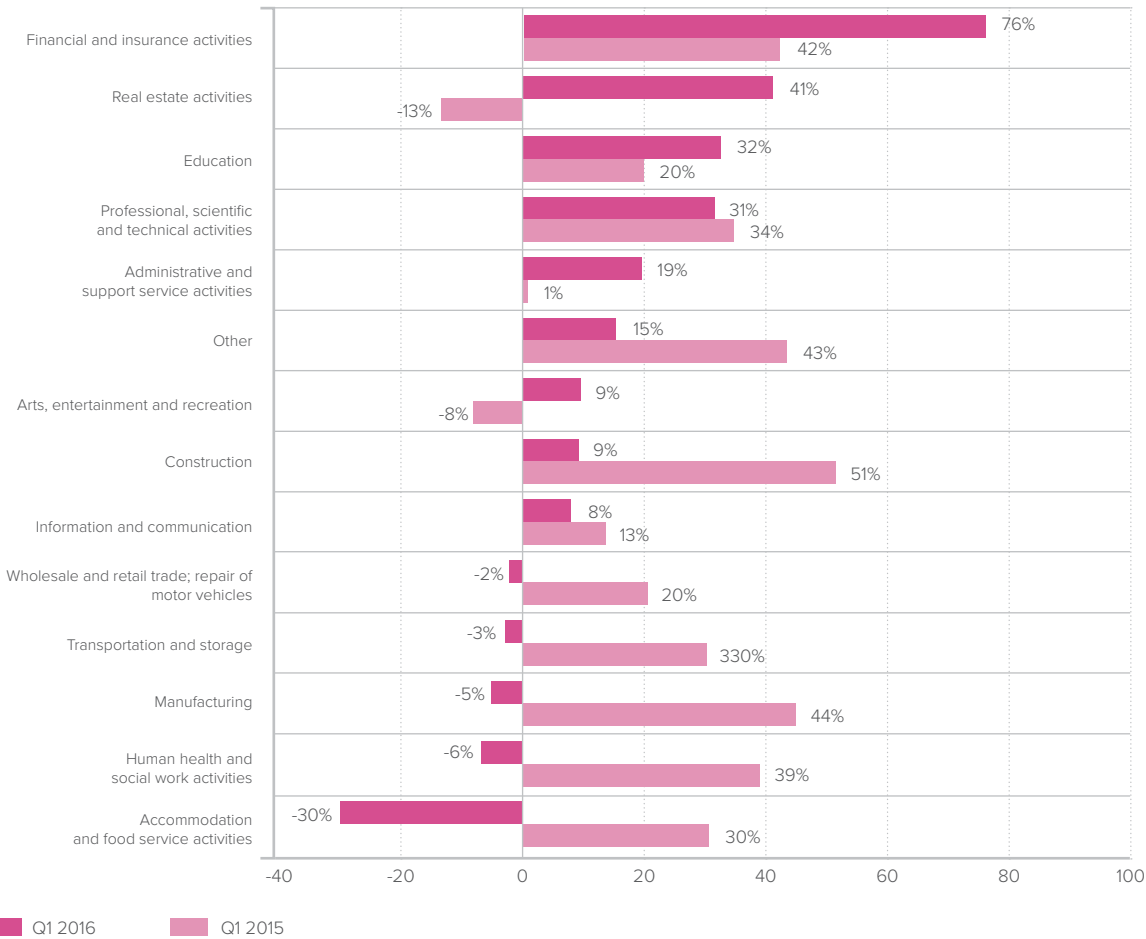


Figure 6: FSB SBI by sector – small business prospects over the next three months

Source: FSB - Verve 'Voice of Small Business' Panel Survey.

REVENUE AND PROFITABILITY

Net revenue and profitability
have fallen

FINANCIAL PERFORMANCE WEAKENS SIGNIFICANTLY

This quarter, a net balance of 6.5% of small businesses report rising turnover over the past three months, sharply down from the 19.5% seen in Q1 2015. Furthermore, the net balance of small businesses reporting rising gross profits has fallen from 12.5% in Q1 2015 to -4.3% this quarter, with more businesses reporting that profits have fallen rather than increased over the past three months. The fact that profits have declined at a time of rising revenues points to a squeeze on small business profit margins in early 2016. Notably, this is taking place before upcoming increases in employment costs such as the National Living Wage.

A net balance of 18.3% of companies expect revenues to rise over the next three months and a net balance of 7.0% expect profit margins to increase. Even if these turnarounds materialise, they would still be the second lowest net balances seen since 2014, after this quarter.

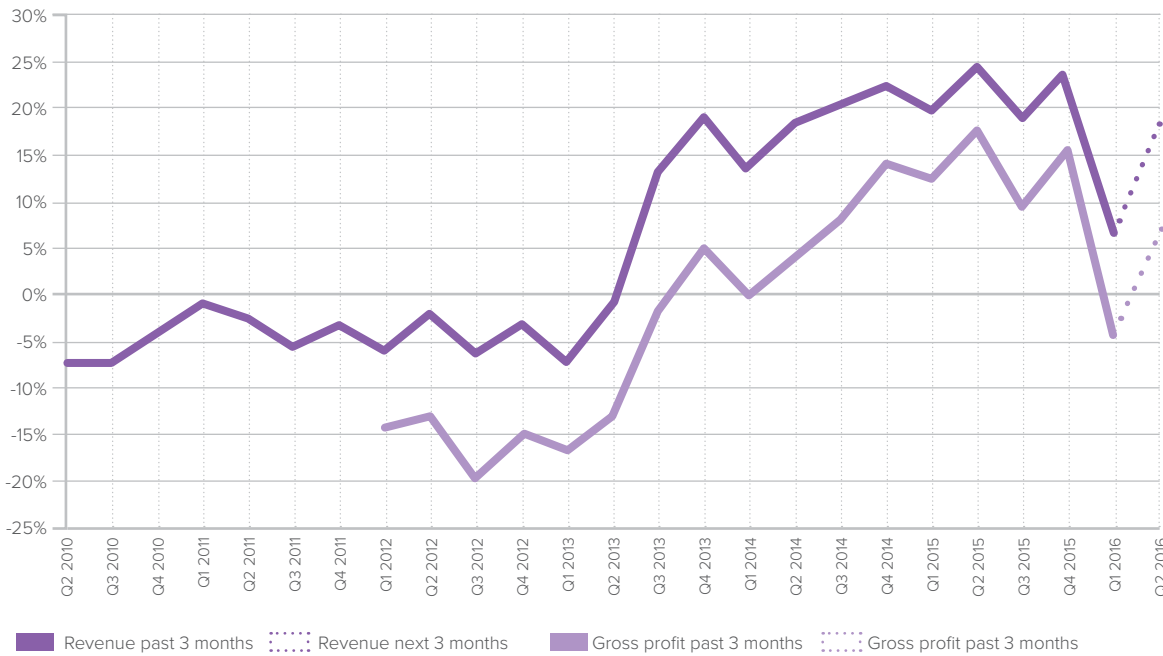


Figure 7: FSB SBI: Revenue growth and gross profit – net percentage balance

Source: FSB - Verve 'Voice of Small Business' Panel Survey. Figures are derived from the proportion of small businesses reporting a net increase less the proportion reporting a net decrease.

EXPORTS

Weakest export performance
since Q4 2012

RECORD LOW EXPORT PERFORMANCE IN Q1 2016

The latest Small Business Index shows exports posting their weakest performance since the data series began at the start of 2012. A net balance of 5.1% of businesses reported that export values declined over the past three months. In contrast, a net balance of 3.1% of businesses in the same quarter a year ago reported that exports were higher than three months ago.

The decline in export performance among small businesses paints a worrying picture of the UK's trading position in 2016. The UK's goods trade deficit – which measures the extent to which the country imports more goods than it exports – stood at a record high level in 2015, despite the fact that the prices of many imports had fallen sharply.

Businesses expect significant improvement in the next quarter. A net balance of 15.9% anticipate that export values will rise over the next three months. A number of factors should help improve the outlook for exporters. Firstly, sterling has weakened sharply against the US dollar and a range of other currencies since the start of 2016, as markets have accepted that the Bank of England is unlikely to raise interest rates this year. This should make the price of British exports more competitive (although by contrast, the cost of imports will increase). Secondly, the economic situation in the UK's largest trading partner, the European Union, appears to be showing tentative signs of improvement with some countries, such as Spain, starting to post more solid economic growth statistics after years of weakness.

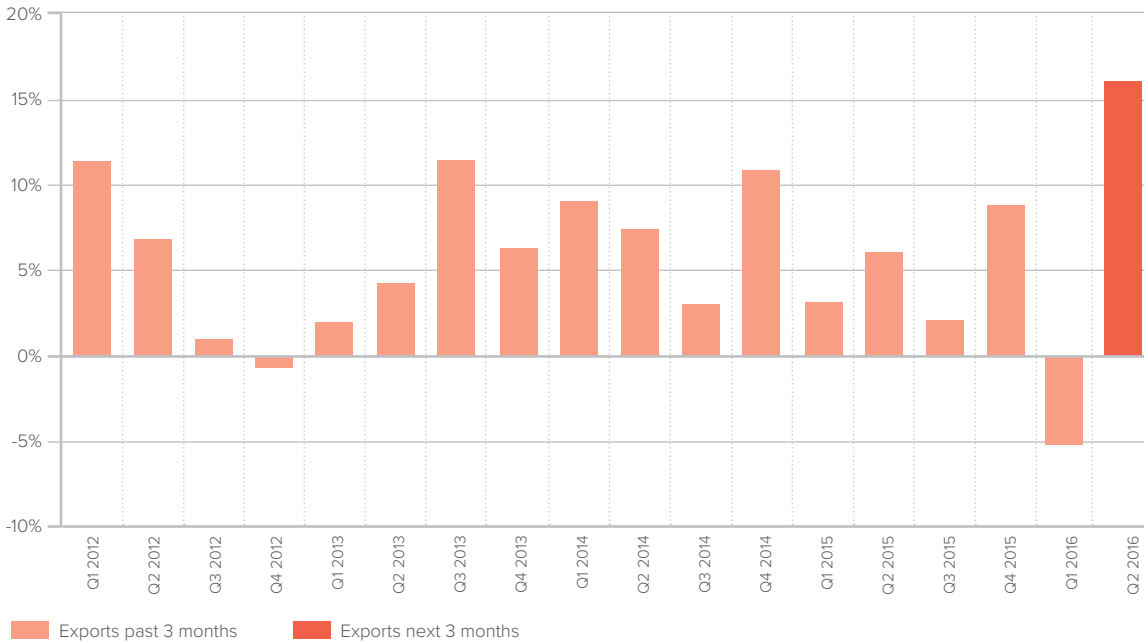


Figure 8: FSB SBI: Change in value of exports – previous three months and expectations for coming three months

Source: FSB - Verve 'Voice of Small Business' Panel Survey. Figures are derived from the proportion of small businesses reporting a net increase less the proportion reporting a net decrease.

COSTS AND INFLATION

Low fuel prices are helping
small businesses

COST PRESSURES FALL BACK

This quarter, a net balance of 46.8% of small businesses report an increase in their overall cost of operation during the past three months, compared with the same period a year ago. This is down from 52.3% in Q4 2015 and ends an upward trend seen since the start of 2015.

Cost inflation pressures for businesses remain modest. Fuel price pressures remain low, with the cost of oil declining further at the start of 2016 – a result of both increasing global supplies and reductions in demand growth as economies such as China slow down. Compared with the first quarter of 2015, the share of businesses citing fuel and utilities to be the main causes of changing operational costs has diminished.

Wage pressures are still subdued, although this could change when the National Living Wage comes into effect from 1st April 2016. As Figure 10 shows, labour costs still pose the highest cost pressure for small businesses, with 43% of respondents citing this as the primary driver of changes in operational costs. The proportion of firms citing regulation and taxation to be major causes of changing operational costs has also increased compared with a year ago – both measures influenced by government policy. This is the likely consequence of upcoming changes to dividend taxation in April, which will significantly increase the tax burden of some companies. Pension auto-enrolment similarly could be a cause of greater numbers of smaller businesses viewing government policy as increasing operational costs, as well as the price of labour.

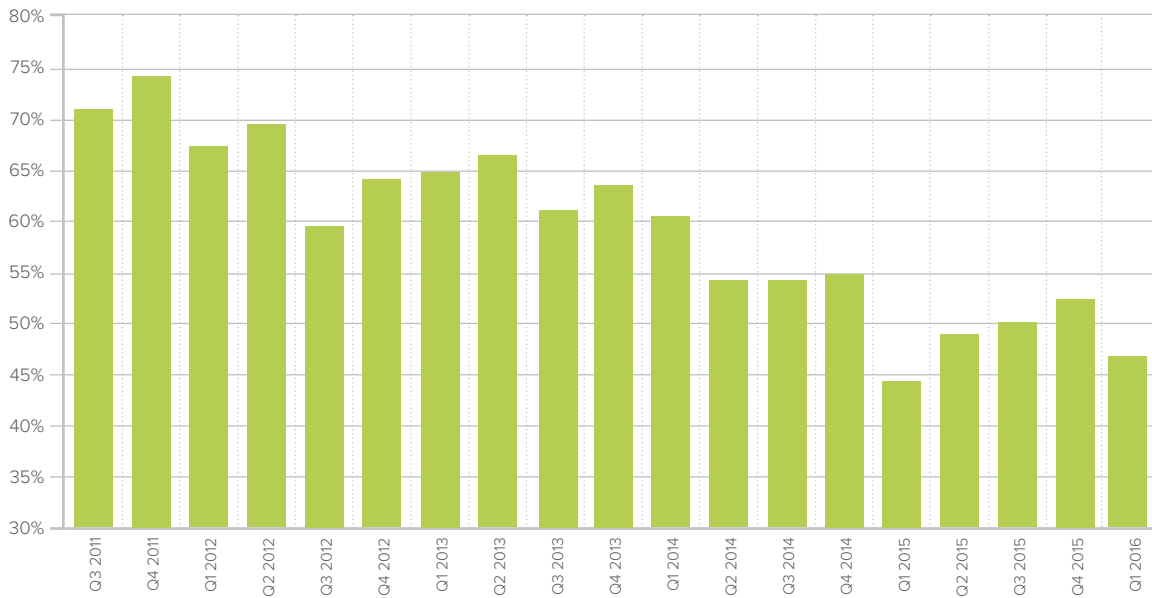


Figure 9
FSB SBI: Net percentage balance reporting increases in overall cost of operation over past three months

Source: FSB - Verve 'Voice of Small Business' Panel Survey

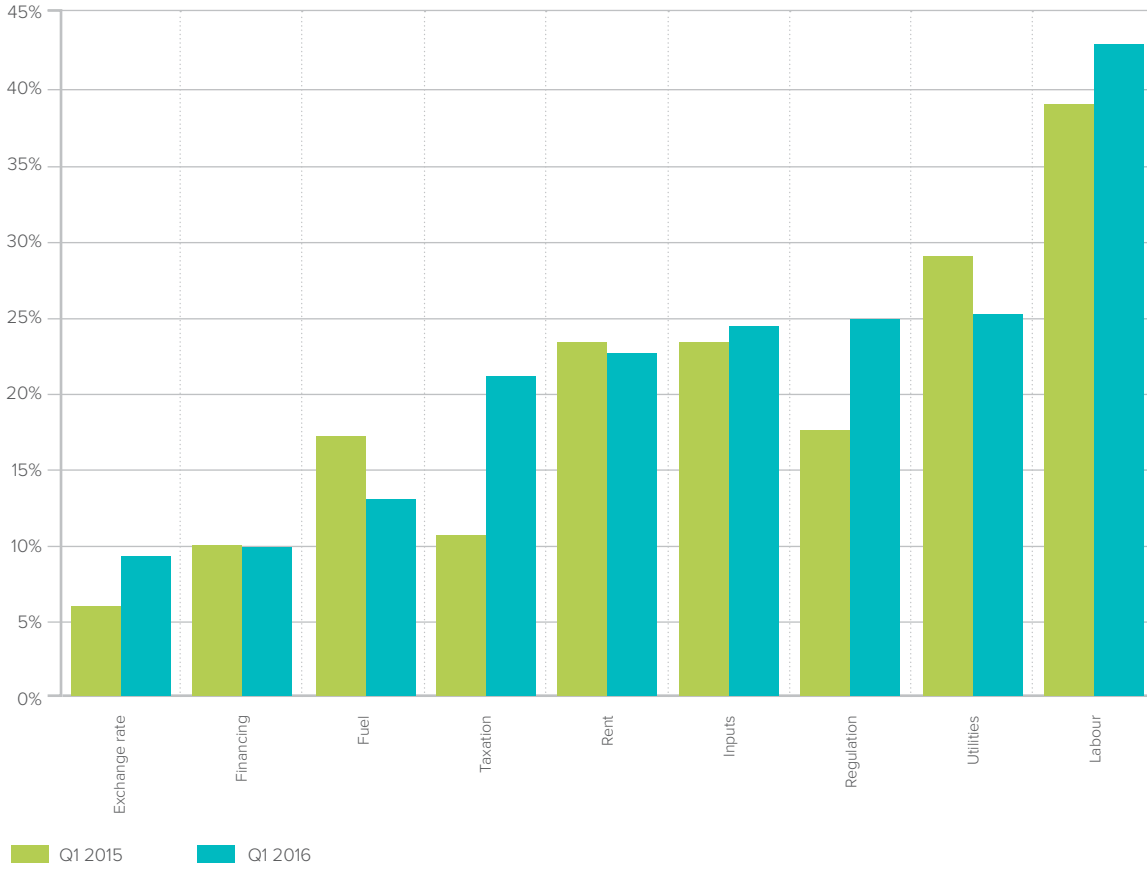


Figure 10:
FSB SBI: Main causes for
changing business costs

Source: FSB - Verve 'Voice of Small Business' Panel Survey. Firms were able to give multiple responses to this question.

CAPACITY

56.8% report operating
below capacity

SHARP INCREASE IN THE SHARE OF BUSINESSES OPERATING BELOW CAPACITY

A net balance of over half (56.8%) of small businesses reported operating below capacity over the past three months, the highest since Q1 2013. The net share of businesses operating below capacity is expected to decline to 47.5% over the next 12 months – still higher than that seen at the end of 2015.

Spare capacity has generally been trending down since the financial crisis, and it remains to be seen if this quarter’s increase is an anomaly or whether there will be greater excess capacity in the economy

throughout this year. This has important implications for monetary policy, with the Bank of England emphasising on a number of occasions that the future path of interest rates will be closely tied to the amount of spare capacity or ‘slack’ in the labour market. The data presented here suggests that an immediate rise in interest rates is unwarranted, with the spare capacity indicator pointing to a significant amount of slack among the UK’s small businesses.

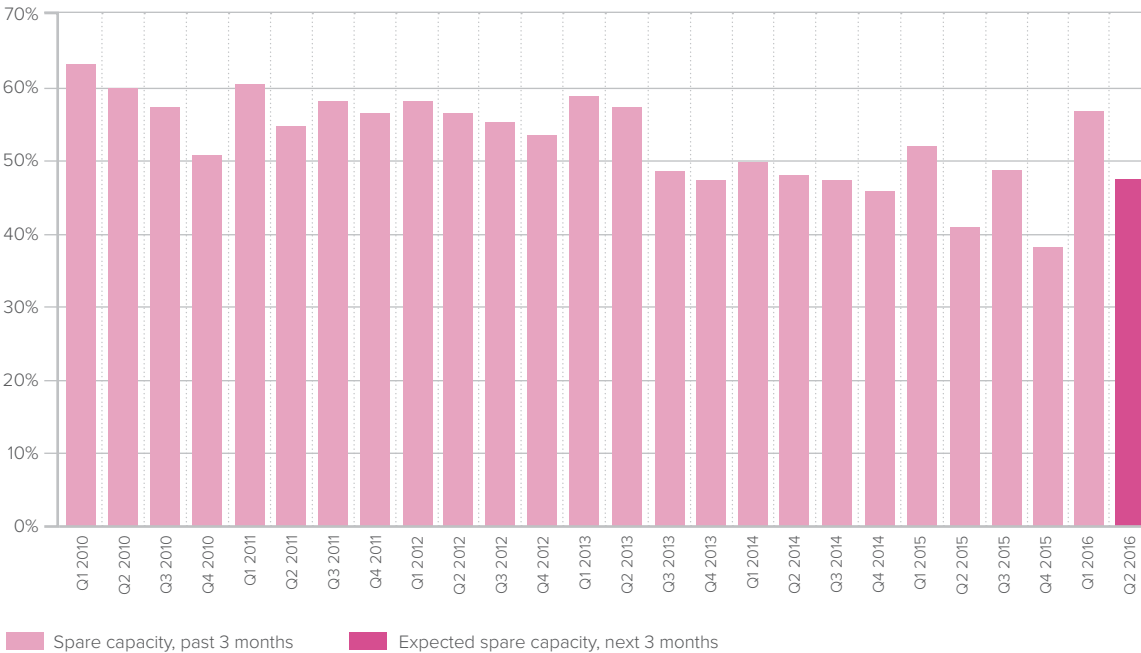


Figure 11: FSB SBI: Net percentage balance of businesses running below capacity

Source: FSB - Verve ‘Voice of Small Business’ Panel Survey. Figures are derived from the proportion of small businesses reporting operating below capacity less the proportion reporting operating above capacity.

EMPLOYMENT AND WAGES

Employment falls for the
first time since 2013

SMALL BUSINESS JOB CREATION WEAKENS

For the first time since 2013, a net balance of small businesses report a decrease in the number of people employed in their organisation this quarter, suggesting that the labour market may have reached something of a turning point. Having said that, a net balance of 7.1% of firms expect staff headcount to increase over the next three months.

There are question marks over how much lower the UK unemployment rate can go, following successive quarters of rising employment and falling inactivity rates. On the latest official labour market data, at the time of writing, which covers Q4 2015, the unemployment rate stood at 5.1%. This was down from 5.7% in the same period a year ago and is the lowest rate of unemployment since the three months to October 2005. Furthermore, the number of people

in employment currently stands at a record high. The latest Small Business Index data point to some stabilisation, or even a slight worsening, in labour market trends in Q1 2016. However, anticipated hiring intentions for the next quarter do revert to positive figures.

It may be the case that companies in the UK are starting to make better use of their existing staff rather than taking on new hires. There is scope for them to do this; 14.9% of part-time employees in the UK would rather work in a full-time job,⁵ so businesses could potentially increase the working hours of these individuals rather than make additional hires.

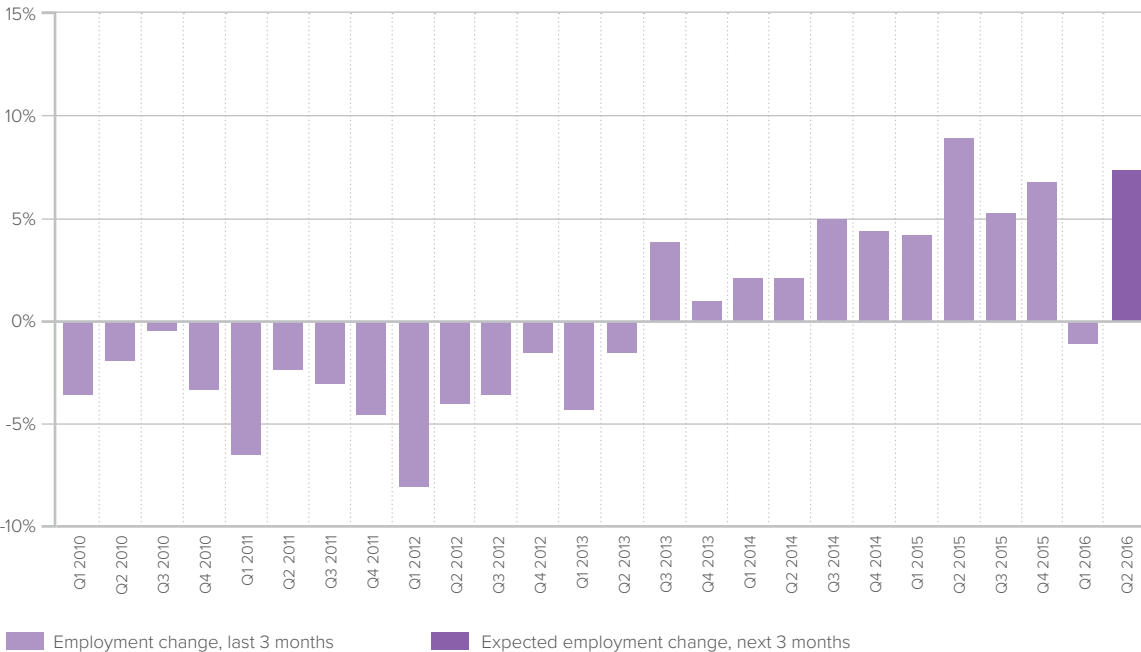


Figure 12: FSB SBI: Net percentage balance change in number of people employed

Source: FSB - Verve 'Voice of Small Business' Panel Survey. Figures are derived from the proportion of small businesses reporting a net increase in employment less the proportion reporting a net decrease in employment.

5. ONS, UK Labour Market, February 2016. Available at <http://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/bulletins/uklabourmarket/february2016>

PAY GROWTH SLOWS

After picking up in Q4 2015, wage growth has slowed in Q1 2016, with small businesses reporting an average salary increase of 1.9% compared with a year ago. This slowdown in pay growth extends beyond small businesses; ONS data showed that the pace of growth in employee earnings cooled towards the end of 2015. It could be that firms are choosing to put off higher pay awards in order to pay for other increases in labour costs, such as pensions auto-enrolment and the National Living Wage. That said, small business pay growth is expected to pick up slightly to 2.0% over the next 12 months.

While these rates of pay growth are modest - average earnings growth across the UK as a whole was over 4% per annum between 2000 and 2007 - it comes at a time of very low inflation, resulting in real terms wage increases for employees of smaller businesses. Even with pay growth of 1.9%, employees in small businesses are seeing a significant increase in their spending power, as pay growth continues to exceed rises in the cost of living.

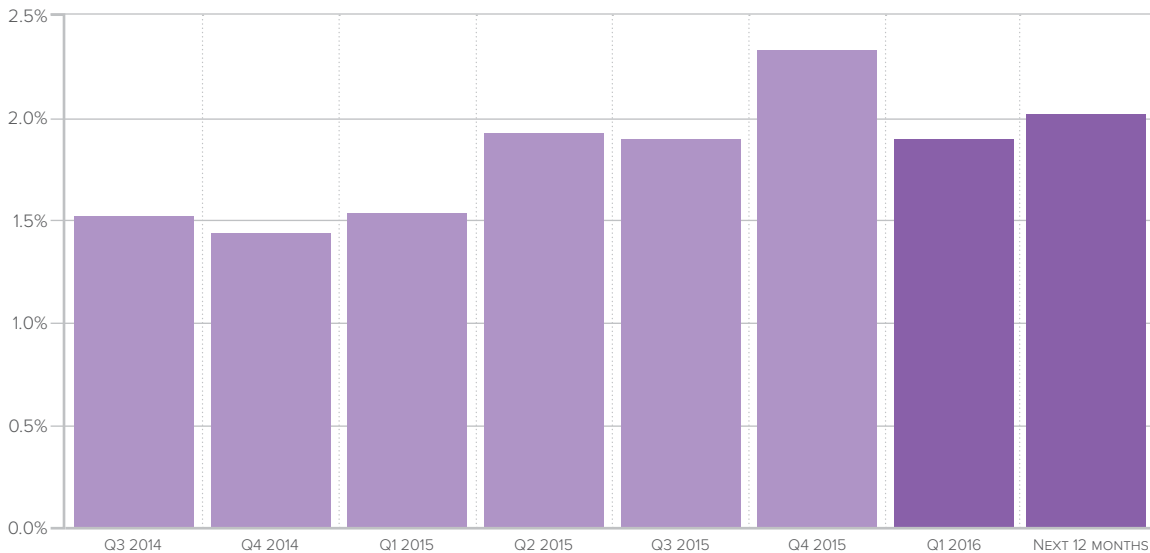


Figure 13: FSB SBI: Average salary increase awarded – this quarter versus a year before

Source: FSB - Verve 'Voice of Small Business' Panel Survey.

PRODUCTIVITY

Productivity growth falls

TURNOVER PER EMPLOYEE LEVELS OFF

After rising since mid-2014, the latest data shows the productivity of small businesses levelling off in Q1 2016. Productivity is defined in this case as inflation-adjusted turnover per employee.

Declining turnover growth has been the prime driver of the slight dip in productivity this quarter. Although small businesses reduced staff headcount slightly in the first quarter of 2016, this still left turnover per employee marginally lower than at the end of 2015. Nevertheless, productivity is still 2.8% higher than a year ago, though this is discernibly lower than the 3.6% year-on-year growth seen in Q4 2015.

Productivity is a key determinant of employee earnings and its levelling off may partially explain the dip in wage growth seen in the latest data. Productivity growth is also a major driver of economic growth in the long run, so it is important that continued gains are realised. As highlighted in Figure 1, data released by the ONS in February showed that economic output per hour worked in the UK was 18 percentage points below the average for the rest of the major G7 advanced economies in 2014, the widest productivity gap since comparable estimates began in 1991.⁶ Without policy interventions to address this gap, the UK economy will continue to struggle to break out of a low growth, low productivity cycle.

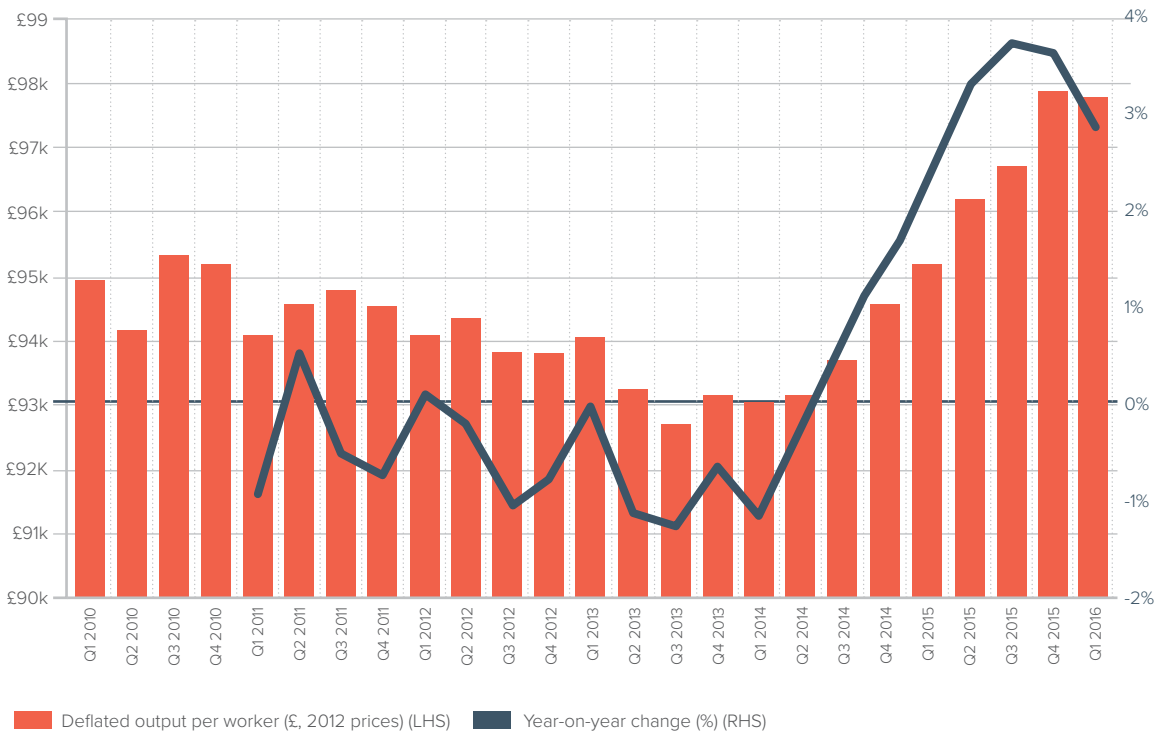


Figure 14: FSB SBI: Small business productivity and year-on-year change (inflation-adjusted turnover per employee)

Source: FSB - Verve 'Voice of Small Business' Panel Survey, Cebr analysis.

6. ONS, International Comparisons of Productivity, February 2016. Available at <http://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/bulletins/internationalcomparisonsofproductivityfinalestimates/2014>

GROWTH ASPIRATIONS AND CHALLENGES

12.8% of firms plan to downsize,
hand over or close

SHARP DECLINE IN SHARE OF BUSINESSES ASPIRING TO GROW

Just over half (52.6%) of small businesses this quarter report having aspirations to grow moderately or quickly over the next 12 months – the lowest share since Q3 2012. Furthermore, 12.8% of companies intend to downsize, close or hand over the business in the next 12 months, sharply up from the recent low of 7.3% seen in Q2 2015.

The share of businesses aspiring to expand tends to be higher for firms in the services sector. Over three fifths of companies in information & communication (64.0%) and financial services (65.5%) aspire to grow moderately or quickly over the next 12 months. In

comparison, just over two fifths (42.2%) of small businesses in the construction sector aspire to grow over the coming year, which will be worrying news for the Government given its ambitions to increase the level of housebuilding in the UK. The construction sector has been struggling; according to the latest data from the ONS, output in the industry contracted by 0.4% between Q3 and Q4 2015.⁷

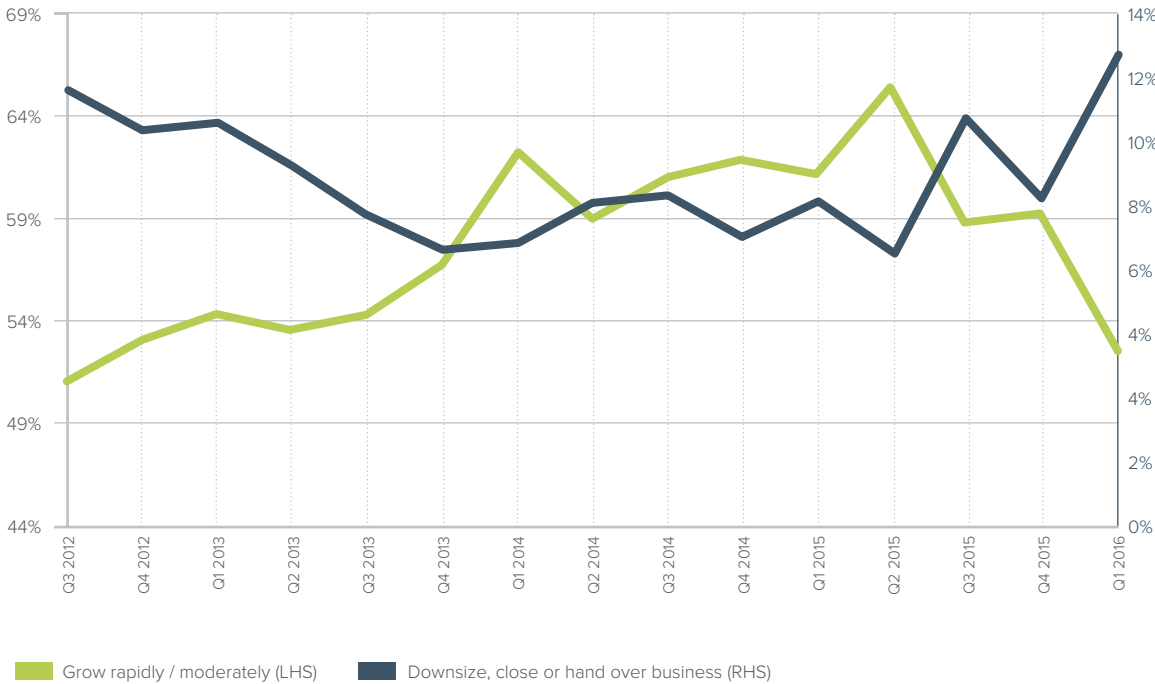


Figure 15: FSB SBI: Growth aspirations for next 12 months

Source: FSB - Verve 'Voice of Small Business' Panel Survey

7. ONS, Output in the Construction Industry, December 2015. Available at <http://www.ons.gov.uk/businessindustryandtrade/constructionindustry/bulletins/outputintheconstructionindustry/december2015andquarter4octtodec2015>

STATE OF THE ECONOMY IS BIGGEST BARRIER FOR SMALL FIRMS

Nearly three fifths (58.1%) of small businesses report that the domestic economy is a potential barrier to achieving their growth aspirations this quarter, sharply up from less than half (49.5%) in Q1 2015. With the UK economy showing clear signs of slowing compared with a year ago, it is unsurprising that greater numbers of small businesses are seeing economic events as a barrier to growth. Even in sectors where consumer demand is strong such as retail, intense price competition among businesses is making for a challenging commercial environment.

The share of small businesses reporting the tax burden and regulation to be a barrier to growth has risen slightly, as has the share reporting labour costs as a barrier to growth. With the National Living Wage coming into effect in April, many businesses are set to see a significant increase in their wage bills. The National Living Wage will start at £7.20 per hour and apply to all employees aged 25 and over, rising to at least 60 per cent of median earnings by 2020.

While the National Living Wage will boost the spending power of many households, there is also a risk that it will lead to job losses as the cost of hiring staff increases. Under the Office for Budget Responsibility's central projections, employment will be 60,000 lower as a result of the National Living Wage by 2020, although by the OBR's own admission, this estimate is fraught with uncertainties.⁸ More positively, the share of businesses reporting a range of cost pressures – input prices, finance, utilities, fuel and rent – to be a barrier to growth has fallen back compared with a year ago.

The share of businesses reporting the foreign economy to be a barrier to growth aspirations has ticked up slightly compared with a year ago, from 13.6% to 15.0%. However, there has been a much larger increase in heavily export-dependent sectors such as manufacturing. Here, the share reporting the foreign economy to be a barrier to growth has increased from 18.3% to 30.2%. This likely reflects growing concerns about the strength and resilience of various export markets in both Europe and other emerging economies.

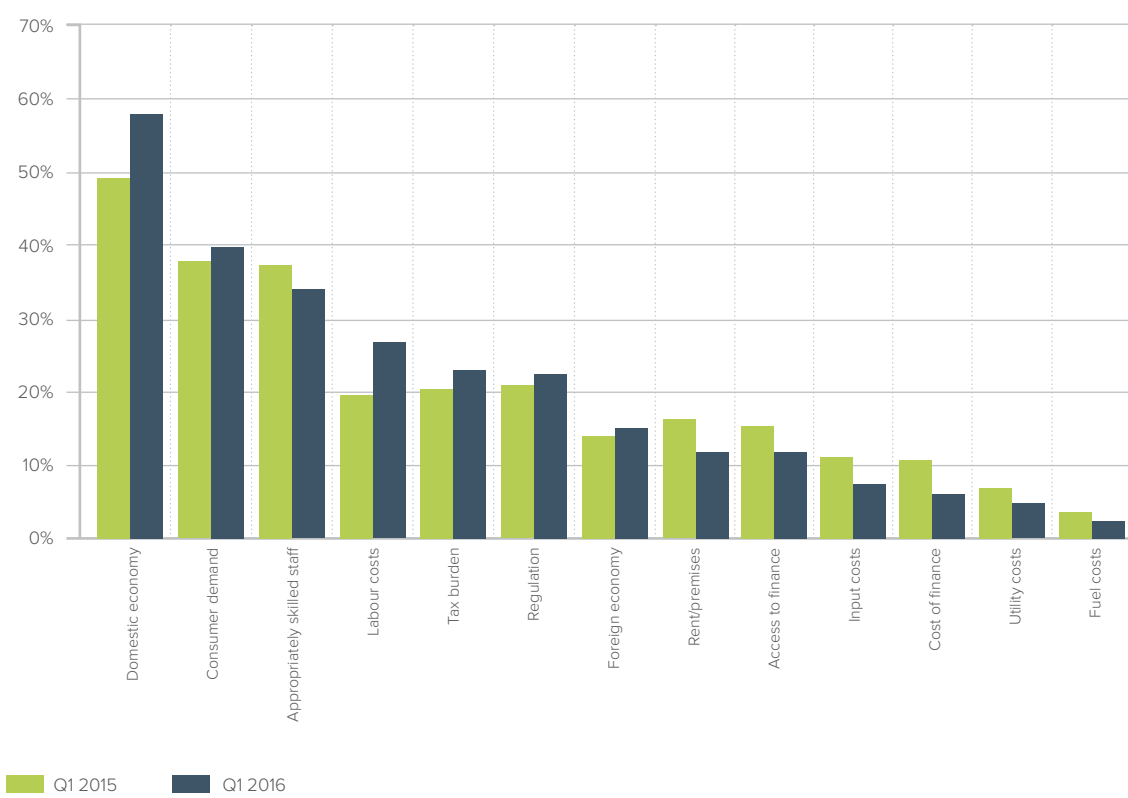


Figure 16: FSB SBI: Potential barriers to achieving growth aspirations

Source: FSB - Verve 'Voice of Small Business' Panel Survey. Respondents were able to give multiple answers to this question.

8. Office of Budget Responsibility, Economic and Fiscal Outlook, July 2015. Available at <http://cdn.budgetresponsibility.independent.gov.uk/July-2015-EFO-234224.pdf>

CREDIT

63% of firms had their loan
application approved

MORE FIRMS SUCCESSFUL IN CREDIT APPLICATION

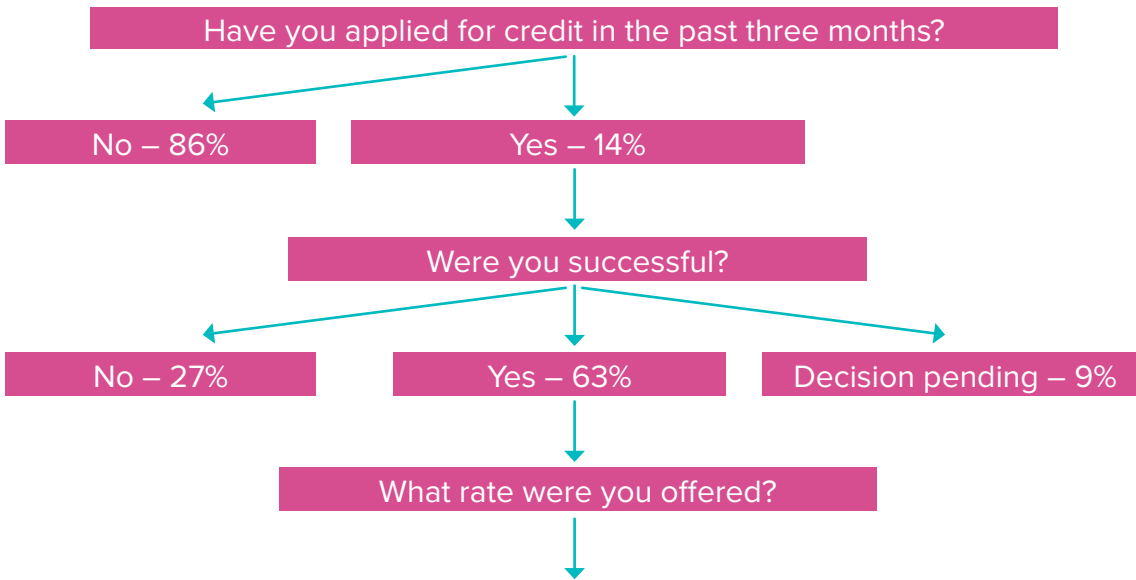
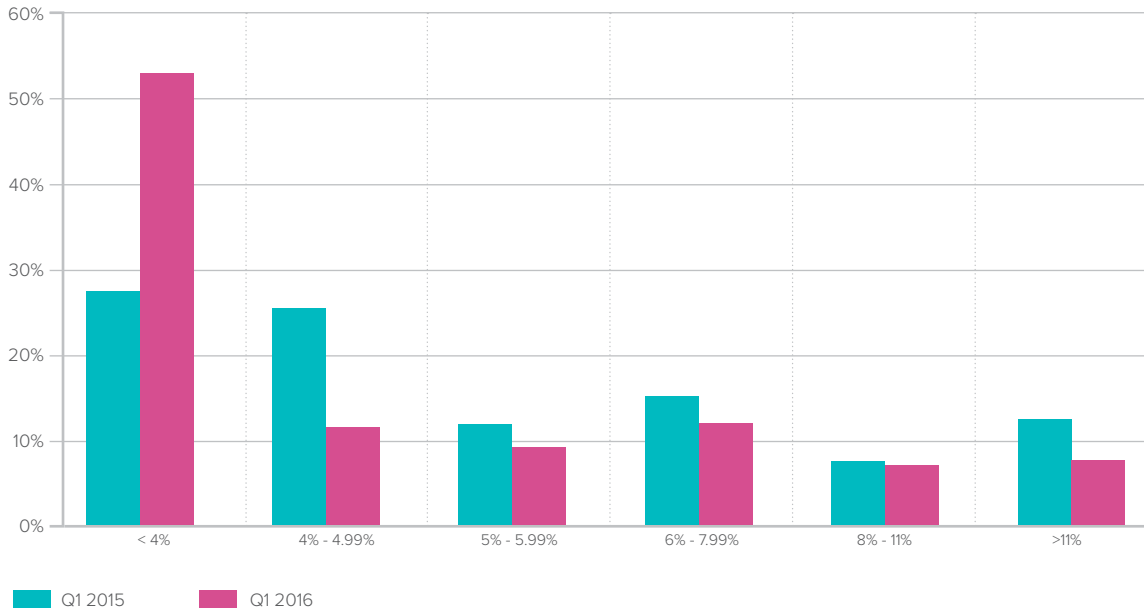


Figure 17: FSB SBI: Credit applications and interest rates offered



Source: FSB - Verve 'Voice of Small Business' Panel Survey

The share of small businesses applying for credit has been steadily falling back over the last few years. In Q1 2012, when this series began, just over one in five firms had made a credit application in the past three months. This figure has generally fallen back since then and stands at just 14% in the latest results. Alongside this trend, a rising share of applicants has

been successful in their bid. Close to two-thirds (63%) this quarter had their loan approved, compared to 45% in 2012. This suggests that either it is becoming easier across the board to get access to finance, or the firms with the weakest financial prospects have stopped applying for credit.

There are also welcome signs that small businesses are increasingly using alternative finance as a way of raising capital. Just under one in ten (9.0%) of small businesses who applied for credit applied for peer-to-peer lending or crowdfunding, up from 3.9% in Q3 2015 and 5.9% in Q4 2015. The share of businesses applying for asset-based financing such as invoice finance has also increased since Q3 2015, when we first started gathering data on the types of finance

applied for. It may be the case that businesses which have been unable to access funds from traditional sources, such as bank lending, are now using these alternative sources of finance to secure funding. Alternatively, the increase in applications may reflect greater awareness of these financial products in the small business community.

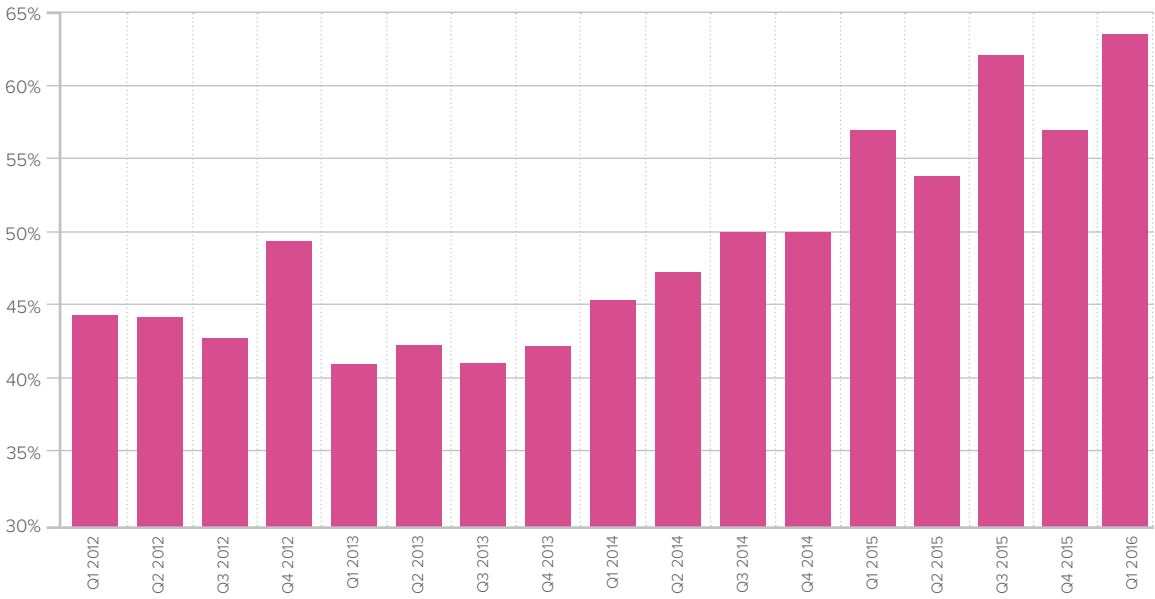


Figure 18: FSB SBI: Proportion of small businesses successful in bank credit (e.g. loan or overdraft) applications in the past three months

Source: FSB - Verve 'Voice of Small Business' Panel Survey

CREDIT AVAILABILITY INDEX STANDS AT A RECORD HIGH

In line with the findings presented in the previous section, small businesses are now finding that both credit availability and affordability is improving. The credit availability index stands at its highest level since records began at the start of 2012. In part, this may reflect the rising use of alternative finance, which has provided small businesses with more options to access capital. Nevertheless, more small businesses believe that the availability of credit is “poor” rather than “good”, suggesting that more needs to be done to ensure that companies can access the capital that they need.

Credit affordability has been assisted by a continuation of loose monetary policy from the Bank of England, which has held down interest rates. It now looks unlikely that the Monetary Policy Committee will vote to raise interest rates in 2016, amid signs of a slowing economy and continued low inflation. Even when interest rates start to rise, the Governor of the Bank of England, Mark Carney, has stressed that increases will be gradual and that the Bank Rate is likely to remain much lower than before the financial crisis.

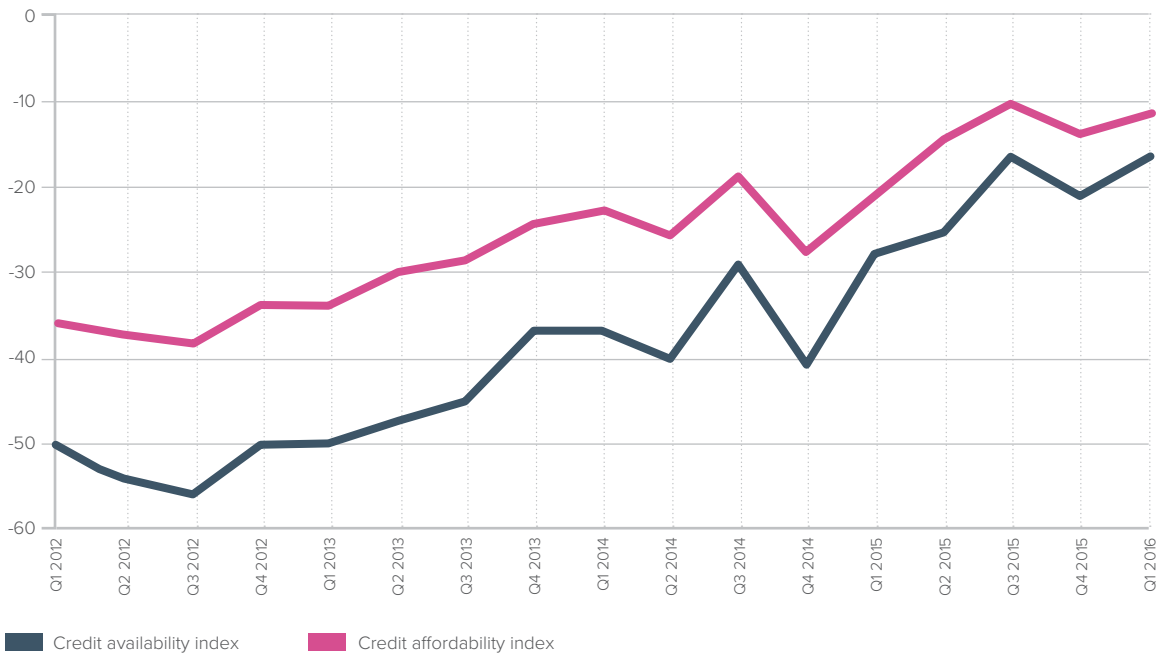


Figure 19: FSB SBI: Indices of credit affordability and availability perceptions over time

Source: FSB - Verve 'Voice of Small Business' Panel Survey. Figures were derived from a weighted net balance of those with negative responses subtracted from those with positive responses.

INVESTMENT

Net balance of 18.5% of firms
plan to increase investment

INVESTMENT INTENTIONS CONTINUE TO FALL BACK

This quarter, a net balance of 18.5% of firms report that they anticipate increasing capital investment over the next 12 months. This is down from 24.9% at the same point a year ago and the lowest net balance since Q2 2013.

The decline in capital spending intentions reflects a number of factors. Rising spare capacity among small businesses has reduced the need to make immediate investments. Significant concerns over the strength of both the domestic and the global economy have also reduced business confidence, which in turn will have fed through into reduced investment intentions. High degrees of uncertainty around the strength of the economy may be causing businesses to adopt a “wait and see” approach to capital spending. Furthermore, for manufacturers, the rising cost of business rates continues to act as a major disincentive to investment in new plant and machinery.

The Chancellor is relying on strong levels of business investment to meet his economic growth projections and, in turn, his public borrowing targets, over the coming years. If small businesses continue to rein in their investment plans, this will have implications for the performance of the whole economy. It also has implications for productivity as without growth in investment, the UK will struggle to narrow its substantial productivity shortfall compared with countries such as France and Germany.

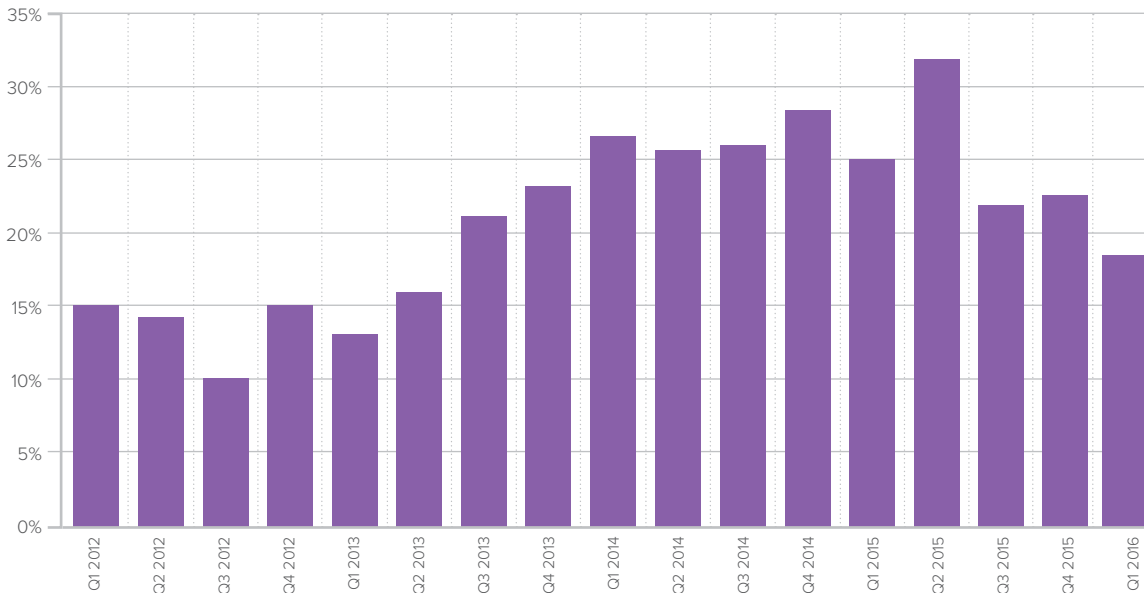


Figure 20: FSB SBI: Net percentage balance in anticipated capital investment growth over next 12 months

Source: FSB - Verve 'Voice of Small Business' Panel Survey. Figures are derived from the proportion of small businesses reporting a net increase less the proportion reporting a net decrease.

METHODOLOGY

This report is based on the January - February 2016 research survey of FSB members carried out by Verve. All panel members (5517 plus 3727 legacy panel members) were invited to take part in an online survey. Reminders were sent to all non-respondents. 1,426 responses were received, a response rate of 15%. The data was weighted by regional gross value added to match the profile of small businesses across the UK. The survey was undertaken between 25 January and 15 February.

SUMMARY DATA TABLE

	Q1 2014	Q2 2014	Q3 2014	Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016
Small Business Index	+35.7	+39.7	+41.0	+17.6	+28.7	+37.9	+20.3	+21.7	+8.6
Employment - previous three months	+2.1%	+2.0%	+5.0%	+4.4%	+4.2%	+8.9%	+5.3%	+6.7%	-1.0%
Employment - coming three months	+7.6%	+10.5%	+7.0%	+7.1%	+10.0%	+14.2%	+8.2%	+7.3%	+7.1%
Revenue - previous three months	+13.1%	+18.1%	+20.0%	+22.0%	+19.5%	+24.1%	+18.8%	+23.9%	+6.5%
Revenue - coming three months	+26.5%	+29.6%	+33.0%	+23.4%	+28.5%	+32.1%	+26.1%	+24.4%	+18.3%
Investment intentions - coming 12 months	+26.6%	+25.6%	+26.0%	+28.4%	+24.9%	+31.9%	+22.0%	+22.5%	+18.5%
Credit availability - rated good or very good	13.5%	12.5%	16.8%	13.3%	16.2%	16.6%	23.5%	18.2%	20.8%
Credit availability - rated poor or very poor	58.5%	60.9%	52.5%	61.7%	50.4%	47.3%	41.6%	43.6%	20.8%
Credit affordability - rated good or very good	19.2%	18.0%	22.0%	18.1%	19.6%	26.2%	27.6%	23.3%	24.9%
Credit affordability - rated poor or very poor	49.8%	51.1%	47.0%	54.4%	46.4%	42.4%	38.8%	40.7%	37.7%

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.

Q1

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