ICAEW BUSINESS OPINION

EXTERNAL DEBT FINANCING OF UK BUSINESSES

July 2010 Research Report

INSPIRING CONFIDENCE

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FOREWORD

In the face of concerns about the fragile recovery in UK economic activity we undertook this survey to see how reliant UK businesses are on debt finance and to better understand the extent to which they are seeking new debt finance facilities.

Our report reveals that there is a limited demand for new debt facilities. This is not surprising as the *ICAEW UK Business Confidence Monitor* reports many businesses are operating below capacity. We believe that businesses' response to the recession of optimising existing debt facilities and stricter management of cashflow is continuing despite evidence of economic recovery. Indeed almost two thirds of businesses feel that their turnover growth in the next two years is not reliant on their ability to increase their external debt facilities.

The measures taken by UK businesses include reducing working capital and cost cutting. Nearly one in five say they have deliberately limited their growth plans and one in eight have resorted to asking shareholders for more equity finance.

The new financial discipline has not been totally voluntary. Around three in ten respondents have experienced pressures from their main lender seeking to cancel, reduce or change the terms of their main debt facility. Large businesses have experienced the least pressure from their bank regarding their debt facilities. Increased costs of renewing existing loans are adding further pressure. Approximately six in ten businesses are reporting increased interest rates and the same proportion higher arrangement fees.

What are the policy implications of our survey? ICAEW believes that debt financing is generally available and there is limited demand for new facilities. Smaller businesses need more help and any changes to the Enterprise Finance Guarantee scheme should be focussed on those businesses. The recession emphasised the importance of sound financial management. Government, finance providers and chartered accountants all have a role to play in ensuring that businesses continue to exercise sound financial control.

Michael Izza

Michael D M Izza
Chief Executive
ICAEW

INTRODUCTION

Between 15 February and 27 May 2010, 1,009 ICAEW members were interviewed about their organisation's use of external debt facilities.

We asked the members about whether they had a need to apply for a new external facility and about their level of success in renewing existing, or applying for a new external debt facility. We also explored how they were managing without renewing an existing, or applying for a new, external facility.

The report highlights that many firms have optimised their existing debt facilities, generated funds internally and reduced their expenditure in the last 12 months in order to meet their financial needs. As they have responded to the changing economic environment by stricter cost control and cash management, firms report a reduced demand for new finances.

The individuals interviewed came from small, medium and large companies across all regions of the UK and all industry sectors, with the exception of the banking, finance and insurance sector. When reading the results, bear in mind that ICAEW membership is biased towards larger businesses, so the sample is not strictly representative of businesses in the UK, but of organisations employing our members. You can find information about the profile of the organisations covered in this research in the technical details section on page 8.

ICAEW works in the public interest to promote enterprise, innovation and sustainable growth in a socially responsible business environment. Our strength and knowledge is drawn from the expertise of over 134,000 members worldwide, who hold world-class finance qualifications. Their experience gives us a detailed understanding of the dynamics that drive our economy.

FINDINGS

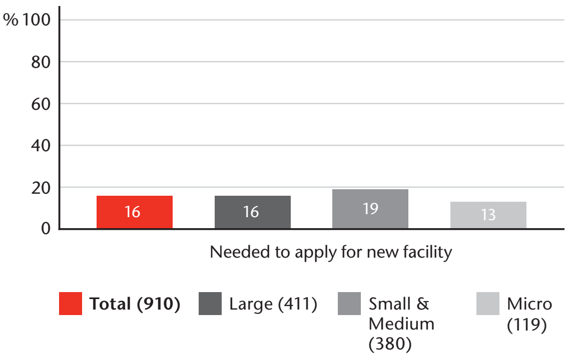
Firms are meeting their financial needs by optimising existing debt facilities and by generating funds internally through stricter cost control and cash management. There is a limited demand for new debt facilities.

There is a limited demand for new debt facilities - fewer than one in five organisations have had a need to apply for a completely new external debt facility in the last 12 months (Fig 1). This reduced demand is not surprising given that many businesses are still operating below capacity as we have recently come out of the recession (the Q2 BCM report indicates that 61% of organisations are currently running below capacity). Furthermore, businesses are cautious about increasing their costs as the economy starts to recover and governments tackle their deficits and respond to the crisis in the eurozone.

The comparatively low level of demand for new debt finance in the last 12 months is evident across different sizes of organisation.

Fig 1. The need to apply for new external debt facility

In the last 12 months, has your organisation had a need to apply for a completely new external debt facility?



Most of the firms that needed to apply for new finance in the last 12 months were successful.

Firms are meeting their financial needs by optimising existing debt facilities and by generating funds internally through stricter cost control and cash management. The three most common strategies adopted by businesses to manage without a new debt facility are meeting their needs through existing debt finance, followed by reduction of working capital and introduction of cost cutting measures. In addition, although to a lesser extent, almost one in five businesses have limited their expansion plans (Fig 2).

The above suggests that sound financial management continues to be important in sustaining businesses as the economy recovers from the recession and starts to grow.

Fig 2. Strategies adopted to manage without a new external debt facility

How has your organisation managed without a new external debt facility?

Base	Total (761)	Large (343)	Small & Medium (315)	Micro (103)
Met needs through existing debt finance	53%	61%	52%	32%
Reduced working capital	45%	48%	46%	29%
Cut costs	43%	46%	43%	29%
Limited growth	17%	17%	17%	18%
Raised equity finance	13%	13%	12%	15%
Reduced service / product range	4%	4%	3%	5%

Base: Those not needing to apply for new external debt facility

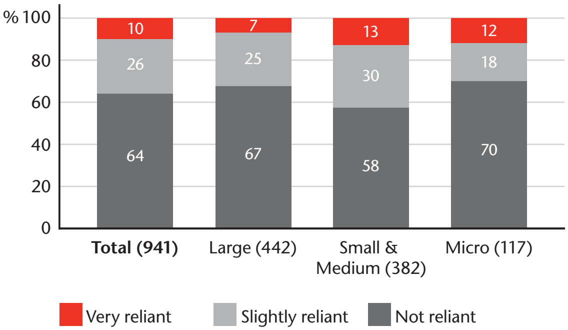
Some Small & Medium and Micro organisations are also relying on their parent company, and using private money for their funding.

Looking at the future, almost two thirds feel that their turnover growth over the next two years is not reliant on their ability to increase external debt financing (Fig 3). This is perhaps a reflection of businesses lowering their capital expenditure and improving management of working capital.

Larger and Micro businesses seem to be less reliant than Small & Medium firms on increasing their external debt facility in order to grow their organisation's turnover in the next two years.

Fig 3. Reliance on increasing external debt facilities in the next two years

To what extent is your organisation's turnover growth in the next two years reliant on your organisation's ability to increase debt financing?



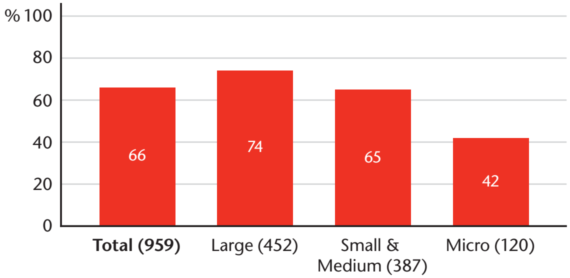
Overdraft facilities and term loans are the most common type of external debt facilities.

Two thirds of organisations currently have an external debt facility (Fig 4).

Not surprisingly, large organisations are more likely than others to have an external debt facility, reflecting their greater need for fixed and working capital to support their operations.

Fig 4. Usage of external debt facility

Does your organisation currently have any external debt facility?



The two most common external debt facilities used by all sizes of businesses are overdraft facilities and term loans (Fig 5), one in four firms use asset based finance.

The use of other types of external debt facilities is generally more prevalent among Larger firms.

Fig 5. Type of external debt facility used

Which type of external debt facility does your organisation currently have?

Base	Total (959)	Large (452)	Small & Medium (387)	Micro (120)
None	34%	26%	35%	58%
Overdraft	49%	57%	46%	27%
Term Loan	43%	50%	41%	27%
Asset based finance	23%	27%	20%	13%
Loan notes	14%	24%	7%	4%
Invoice discounting	9%	8%	13%	2%
Corporate bonds	7%	13%	1%	2%
Mezzanine finance	5%	8%	3%	2%
Debt factoring	4%	7%	3%	1%

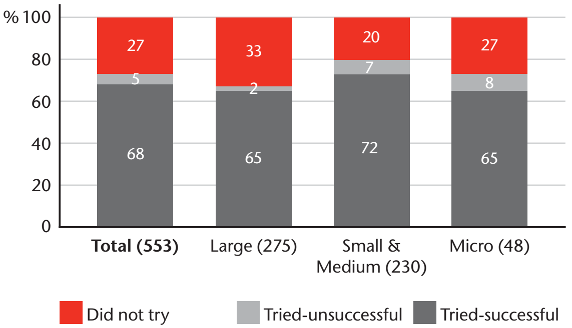
Lender environment is tighter but many businesses are successful in re-financing their external debt facilities or obtaining a new one.

The majority of those re-financing an existing debt facility, in the last 12 months, were successful (Fig 6).

Fig 6. Success in renewing an existing external debt facility

In the last 12 months, has your organisation tried to renew an existing debt facility - either with the same supplier or a new one?

Was your organisation able to obtain the new debt facility?



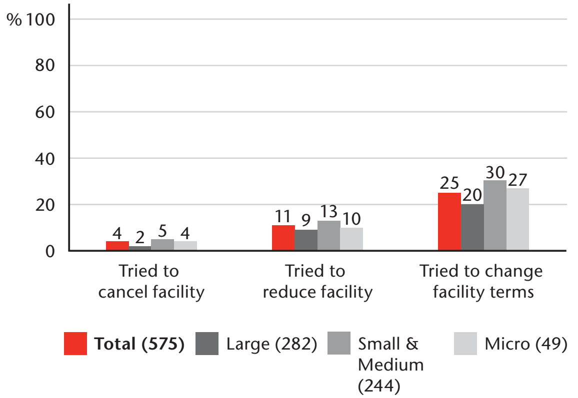
Base: Those with external debt finances to renew

But, as might be expected, organisations report a tighter lending environment over the last 12 months.

- Most (58%) of those renewing an existing facility in the last 12 months report an increase in the interest rate compared to their previous arrangement.
- The same proportion cites an increase in arrangement fees when re-financing their facility.
- 29% of businesses have experienced some pressures from their main lender in the past 12 months as the lender tried to alter their main debt facility - most commonly attempting to change the terms of the facility (Fig 7). Small & Medium firms have experienced more pressures than others from their main lender.

Fig 7. Changes in the main debt facility

Has your organisation's main lender tried to make any of the following to your organisation's debt facility over the last 12 months?

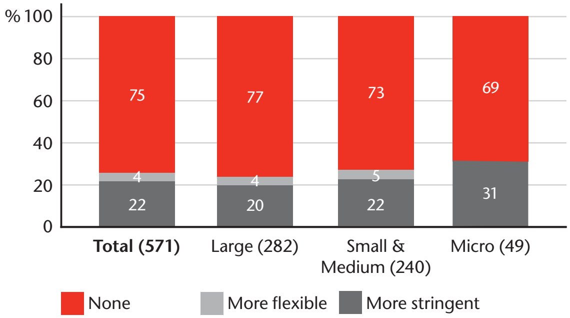


Base: Those with an external debt facility

- Moreover, over one fifth (22%) of organisations report their main lender becoming more stringent in applying the terms of their main facility (eg, technical breaches of covenants) in the last 12 months (Fig 8).

Fig 8. Changes in the way the main lender applies the terms of the main facility

Has your organisation's main lender changed the way it applies the terms of your organisation's main facility?



Base: Those with an external debt facility

APPENDIX

KEY FINDINGS BY SECTOR

Businesses in the property sector (which includes both commercial and residential properties) have experienced the most pressure from their main lender, compared to other sectors: nearly two fifths report that the terms of their main facility (eg, technical breaches of covenants) have become more stringent in the last 12 months. Furthermore, almost a quarter report that the main lender has tried to reduce their main facility.

	Business Services N=124	Construction N=81	IT N=55	Manufacturing & Engineering N=187	Primary N=78	Property N=90	Retail & Wholesale N=165	Transport & Storage N=70	Other Service N=62
Does your organisation currently have an external debt facility?									
Yes	64	68	54	69	64	72	67	73	62
In the last 12 months has your organisation had a need to apply for a new external debt facility?									
Yes	9	20	6	11	29	22	16	25	12
Is your organisation's turnover growth in the next two years reliant on your organisation's ability to increase external debt financing									
Yes	27	42	25	38	36	53	36	42	32
THOSE WITH AN EXTERNAL DEBT FACILITY TO RENEW									
	Business Services N=63	Construction N=52	IT	Manufacturing & Engineering N=107	Primary N=45	Property N=60	Retail & Wholesale N=92	Transport & Storage N=45	Other Service
In the last 12 months has your organisation tried to renew an existing external debt facility – either with the same supplier or a new one?									
Yes	68	77	**	69	87	85	75	69	**
THOSE WHO HAVE AN EXTERNAL DEBT FACILITY									
	Business Services N=72	Construction N=53	IT	Manufacturing & Engineering N=123	Primary N=49	Property N=64	Retail & Wholesale N=104	Transport & Storage N=49	Other Service
Has your organisation's main lender tried to make any of the following to your organisation's debt facility in the last 12 months?									
Tried to cancel facility	2	4	**	2	2	11	3	4	**
Tried to reduce facility	3	16	**	10	2	23	10	11	**
Tried to change facility terms	18	31	**	25	10	38	31	20	**
Has your organisation's main lender changed the way it applies the terms of your organisation's main facility?									
More stringent	19	24	**	17	5	38	26	13	**

**NOTE: Only answers with base 40+ are shown here. Findings from those sectors with a base of less than 50 should be treated with caution.

KEY FINDINGS BY REGIONS

Nearly a third of businesses in the North West region have experienced some pressure from their main lender in the last 12 months as their lender tried to change the terms of their main facility. Over a quarter of firms in this region report that the terms of their main facility (eg, technical breaches of covenants) have become more stringent in the last 12 months.

	London N=157	South East (excl. London) N=150	South West N=72	East England N=96	East Midlands N=77	West Midlands N=75	North West N=103	Northern England N=68	Yorks & Humber N=79	Scotland N=66	Wales N=65
Does your organisation currently have an external debt facility?											
Yes	61	66	74	63	67	64	72	69	68	65	62
In the last 12 months has your organisation had a need to apply for a new external debt facility?											
Yes	17	20	19	9	18	10	21	19	10	18	17
To what extent is your organisation's turnover growth in the next two years reliant on your organisation's ability to increase external debt financing?											
Yes	35	35	38	38	47	30	39	33	28	41	35
THOSE WITH AN EXTERNAL DEBT FACILITY TO RENEW											
	London N=79	South East (excl. London) N=83	South West	East England N=55	East Midlands N=48	West Midlands	North West N=61	Northern England	Yorks & Humber N=45	Scotland N=40	Wales
In the last 12 months has your organisation tried to renew an existing external debt facility – either with the same supplier or a new one?											
Yes	77	73	**	71	71	**	80	**	69	70	**
THOSE WHO HAVE AN EXTERNAL DEBT FACILITY											
	London N=89	South East (excl. London) N=93	South West N=49	East England N=59	East Midlands N=51	West Midlands N=47	North West N=71	Northern England N=44	Yorks & Humber N=51	Scotland	Wales
Has your organisation's main lender tried to make any of the following to your organisation's debt facility in the last 12 months?											
Tried to cancel facility	5	4	2	0	6	3	4	0	9	**	**
Tried to reduce facility	9	7	7	13	13	8	13	20	11	**	**
Tried to change facility terms	21	20	26	21	23	23	31	33	21	**	**
Has your organisation's main lender changed the way it applies the terms of your organisation's main facility?											
More stringent	21	11	24	25	23	20	27	**	22	**	**

**NOTE: Only answers with base 40+ are shown here. Findings from those sectors with a base of less than 50 should be treated with caution.

TECHNICAL DETAILS

Between 15 February and 27 May 2010, we interviewed 1,009 ICAEW members who work in industry and commerce (ie, outside accountancy practice), to find out about their organisation's use of external debt finance.

The interviews were conducted by telephone as part of ICAEW's *UK Business Confidence Monitor.*

Those interviewed are from Micro, Small & Medium, and Large organisations, located across the UK and based in a broad range of industry sectors with the exception of those in the banking, finance and insurance sector. About half (513) are from Micro, Small and Medium-sized enterprises (up to 249 employees); the remainder (496) represent companies of 250 or more employees.

The sample of Micro, Small and Medium businesses, compared to Large ones, is not in line with the incidence of sizes of these businesses in the UK as a whole. You should bear in mind that, due to the types of firms in which ICAEW members tend to be employed, the companies covered have a natural emphasis towards the larger end of Small and Medium companies (those with 50 – 249 employees).

The figures in this report are based on those answering each question (they exclude the 'Don't know' responses). The actual base of those being able to answer a question is shown in each case.

The table on the following page describes the profile of the organisations contacted in this survey.

Further information

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REGION	No of interviews
London	157
South East (excl London)	150
South West	72
East England	96
East Midlands	77
West Midlands	75
North West	103
Northern England	68
Yorks & Humber	79
Scotland	66
Wales	65
Northern Ireland	1
TOTAL	**1,009**

SECTOR	No of interviews
Business services	124
Communications	31
Construction	81
Health and Education	46
Hotels and Catering	20
IT	55
Manufacturing and Engineering	187
Other service activities	62
Primary*	78
Property	90
Retail and Wholesale	165
Transport and Storage	70
TOTAL	**1,009**

*Primary includes agriculture and fisheries, energy, water and mining

SIZE (EMPLOYEES)	No of interviews
Micro (1 – 9)	121
Small (10 – 49)	165
Medium (50 – 249)	227
Large (250+)	496
TOTAL	**1,009**

The ICAEW is a founder member of the Global Accounting Alliance, which represents around 775,000 of the world's leading professional accountants in over 165 countries around the globe, to promote quality services, share information and collaborate on important international issues.

As a world-class professional accountancy body, ICAEW provides leadership and practical support to over 134,000 members in more than 160 countries, working with governments, regulators and industry to maintain the highest standards.

Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. ICAEW ensures these skills are constantly developed, recognised and valued.

Because of us, people can do business with confidence.

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