The uneven recovery

April 2022

POWERED BY CLARITY

www.quantuma.com/unevenrecovery

Contents

Foreword

Carl Jackson, CEO

It brings me great pleasure to introduce our 2022 programme of insight and support, 'The uneven recovery', powered by our new and unique data asset, Clarity.

The pandemic has had an uneven impact on the UK across regions and sectors. We believe the impact will lead to the emergence of a new class of 'winners' and 'losers' driven by unique growth and distress factors. Over the coming months, we will look at what this divergent recovery means for UK SMEs and how best to position a response to ensure the continued viability and prosperity of this vital segment of the UK economy.

How Clarity has been developed

Developed by an expert analytics team:

The UK's leading team of data scientists have contributed to the development of Clarity, including individuals that previously advised the UK Government on the impact of the pandemic on SMEs.

More than 30 years of analysis and insight:

Clarity has been built on solid foundations. The data is taken from over 30 years of historical analysis to ensure the model is robust.

Powered by leading data assets from Experian:

Clarity takes data from multiple sources including a set of industry-leading assets from Experian that create forward-looking indicators on both growth and distress.

How Clarity will benefit you and your clients

Forward looking to spot opportunities:

Clarity can equip you with a forward-looking, data-led view on the forces that are shaping the UK SME market so you can spot opportunities to grow your practice in specific sectors or region.

Working with existing clients:

It will empower you to proactively work with existing clients, to advise them on how to position their businesses for success and to avoid risk of failure.

Developing your offering:

The data provides an empirical basis for you to develop new propositions and capabilities to support SMEs at risk of failure and those that will be future growth champions.

Developing your knowledge:

Clarity can help you develop a detailed understanding of the relative importance of sectors and regions when considering winning strategies for local SMEs.

Acknowledgements

LAECEUM
STRATEGY I ADVISORY I DATA I ANALYTICS

Clarity has been created in partnership with Laeceum, a London-based advisory and consulting boutique specialising in strategic R&A, SME data and analytics, corporate strategy, and corporate development and advisory. The Laeceum team comprises Founder Ravi Chauhan, Senior Advisor John Mould, Analyst Oliver Benson, and Economist Anjalika Bardalai.

You can find out more about Laeceum here: www.laeceum.com

What's to come

This programme will include a series of linked, data-rich reports sharing exclusive insight into what Clarity is signalling about future growth and distress trends, and who the likely winners and losers will be in the post-pandemic recovery, comparing performance across a range of industry sectors and key UK regions.

In this first report, we publish the UK's headline outlook, drawing upon major macro-economic trends and drivers and broad sectoral analysis, summarising insights from over 20 UK sectors based on standard industry classifications. Following this, we will publish a series of regional reports covering the Eastern, Midlands (incorporating East and West), London, South West and Wales, South East, Scotland and the North (incorporating the North West, North East, Yorkshire and the Humber) regions. The programme will also give you access to a series of webinars, in-person events, and roundtables to provide you with a forum to explore the detail and what this means for you as advisers and what it means for your clients.

A common methodology and analytical framework will underpin each of the regional reports, enabling cross-sectoral and cross-regional comparisons. Each report will include a range of charts and analysis drawn from Clarity, enabling us to generate grounded and data-driven insight on the forces shaping the UK SME landscape at regional and sectoral levels.

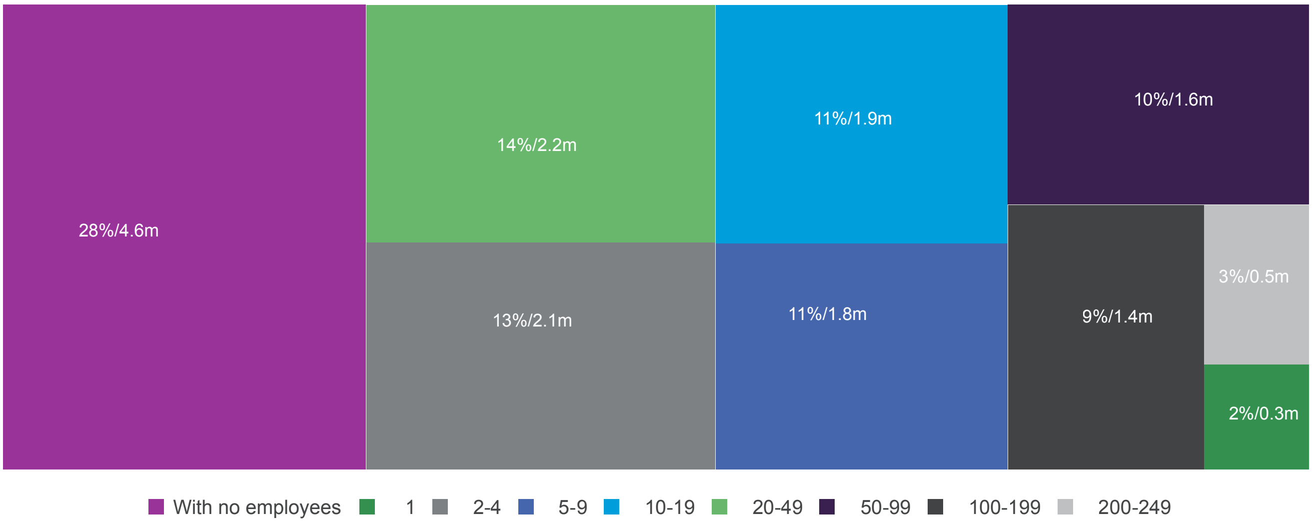
Looking further ahead, we will refresh our analysis in September, comparing the results with what we have seen in our first series of insights produced and distributed in the coming months.

SMEs and the uneven recovery

Brexit and Covid-19 have disrupted the UK economy, and, now with the potential pressures that the war in Ukraine is likely to pose, we believe that now is the time to secure the continued viability and prosperity of the UK SME community. We urge other professionals and lenders to use insight from Clarity to help SMEs make actionable and data-led decisions to ensure the long-term prospects of this vital segment of the UK economy.

Over 50% of UK SMEs have fewer than 10 employees and almost 30% have none at all

UK SMEs by Employees, 2021



Source: BEIS, Quantuma Clarity

Rounding errors may occur

It is widely understood that the pandemic has not had a uniform effect on SMEs across regions and sectors. Whilst the uneven nature of the impact is well documented; Clarity provides predictive insight into how this will affect SMEs in the future. Specifically, it focuses on understanding the key drivers of growth and distress.

SMEs that had a 'good pandemic' have reported record sales, if not necessarily profitability due to pressures on supply chains and the need to re-engineer business and operating models. For other SMEs, the pandemic has proved catastrophic. Business models have been upended and in some cases a transition to an online-only model has provided temporary relief only, in the form of reduced turnover without a corresponding reduction in fixed costs and overheads, resulting in a dramatic squeeze on cash flow and profitability.

The fundamental shift in buyer behaviour and channel preference is likely to endure, resulting in an 'adapt or die' choice facing many thousands of the UK's SME business owners and affecting many thousands of livelihoods.

How Clarity works and some early insight

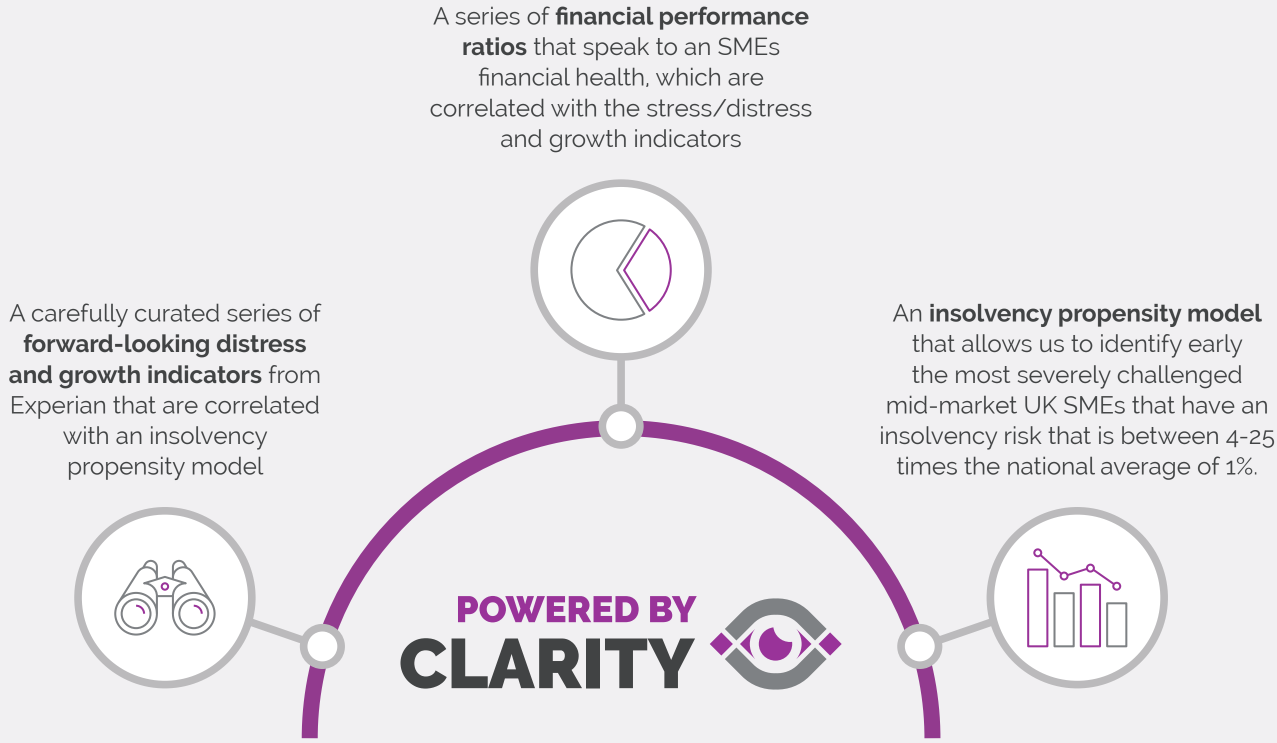
We are excited that the programme will be informed by Clarity, our new and unique data asset. We have developed the model in partnership with Laeceum to support the advisory and lending community in developing predictive insight into the health of the UK's SME community.

This insight has enabled us to engage with struggling SMEs before they fail and to engage with potential growth champions of the future. In doing so, we have been able to successfully ensure the viability of SMEs that have been adversely impacted by Brexit and Covid-19 whilst at the same time, helping SMEs on a growth path to scale-up at pace.

Clarity takes data from multiple sources and then analyses and benchmarks that data to identify the sectors that are under the most stress and need help to recover, the regions that have fared better over the last two years, and pinpoints businesses that have the greatest propensity for collapse and those that are set to grow.

"Clarity provides predictive insight ...Specifically, it focuses on understanding the key drivers of growth and distress."

Specifically, the model comprises three components:



Forward-looking growth and distress indicators

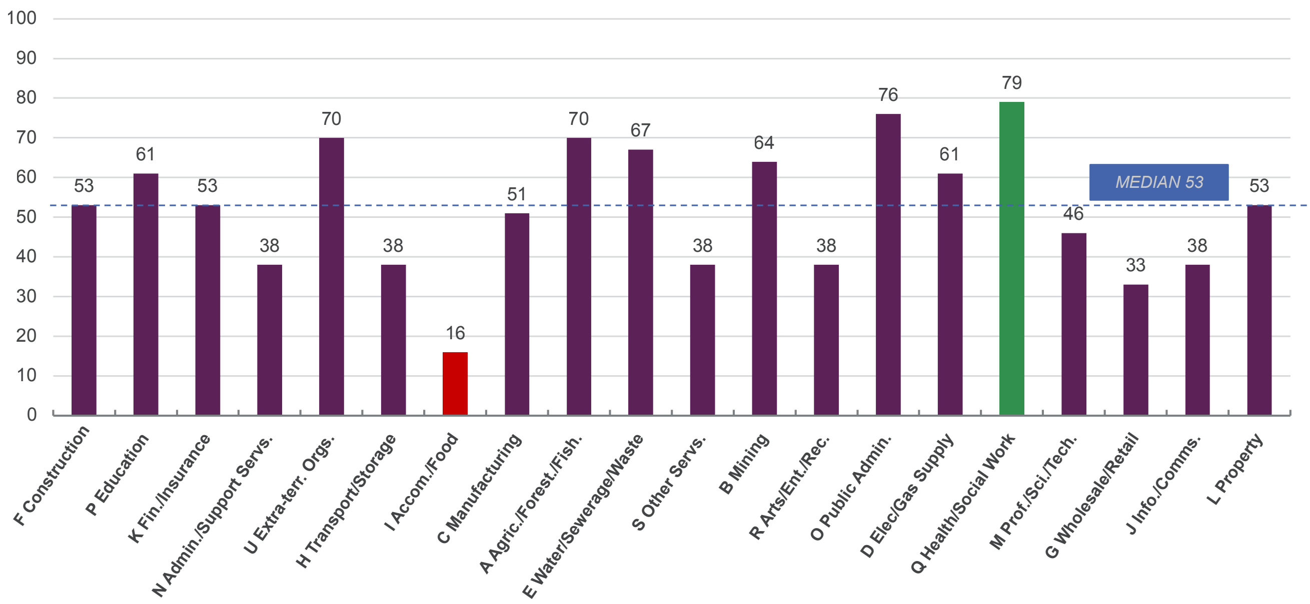
The first component of Clarity is a series of **forward-looking distress and growth indicators**. Their predictive nature and analytical basis helps to offset the latency effects of relying on financial information alone (which at times can be as old as 12 months at the point of application):

- **Commercial Delphi (CD):** a single harmonised score from 0-100 (where 100 is best) to help establish the commercial viability of companies, combining company accounts, payment performance, director information and consumer scores, helping to predict defaults and creditworthiness.
- **Growth Score (GS):** a measure of growth from 0-100 (where 100 is best) influenced by historic and forecast YoY turnover growth and YoY employee growth.
- **Financial Strength Score (FSS):** a measure of financial viability from 0-100 (where 100 is best) trained to look for insolvency (liquidation, receivership, and administration) over a 12-month horizon using filings history, financial information, corporate and organisational data and other leading indicators.
- **Distress Warning Score (DWS):** a blended score from 0-20 (where 20 is best) trained to identify SMEs that are likely to default over the next three to six months. It combines credit information with invoice settlement delinquency and County Court Judgements, producing a score that helps identify businesses that are in distress and potentially at risk of failing within the short to medium term.

By way of illustration and using FSS as an example, the chart below shows that the median FSS for UK SMEs is 53 and that SMEs in the Accommodation/Food sector in SIC divisions 55[1] and 56[2] have the lowest FSS at 16. This is entirely consistent with expectations given the profound impact of Covid-19 and consequent lockdown restrictions on occupancy and footfall. Conversely, SMEs in the Health/Social sector in SIC divisions 86[3] , 87[4] and 88[5] have the highest FSS due to the extraordinary impact the pandemic has had on demand for services with the same holding true for SMEs in the Public Administration sector in SIC division 84[6].

Health/Social work is significantly outperforming the UK in terms of financial stability whereas Accommodation/Food sector is underperforming by a very significant margin

Financial Strength Score (FSS), February 2022, 0-100



Source: Quantuma Clarity

The question we ask ourselves is how sustainable is outperformance by a sector that has clearly had a 'good Covid' and how enduring is the underperformance of a sector that has historically been a significant constituent of the total UK SME market but had a 'bad covid?' Do we expect to see a reversion to the mean? If so, are signals already present in any of the forward-looking indicators or the financial performance ratios, for example? We will examine these questions and many others in greater detail during this programme.

[1]Includes hotels, holiday centres, youth hostels, short-stay accommodation, camping grounds, etc
[2]Includes restaurants, takeaways, cafes, clubs, bars, pubs, event caterers etc
[3]Includes hospitals, nursing homes, GPs, dentists etc
[4]Includes residential nursing homes, residential care activities for the elderly and disabled
[5]Includes non-residential social work, child daycare
[6]Includes the administration of local services such as health, education, cultural services, public order and justice, social security, legal and justice etc

Financial performance ratios

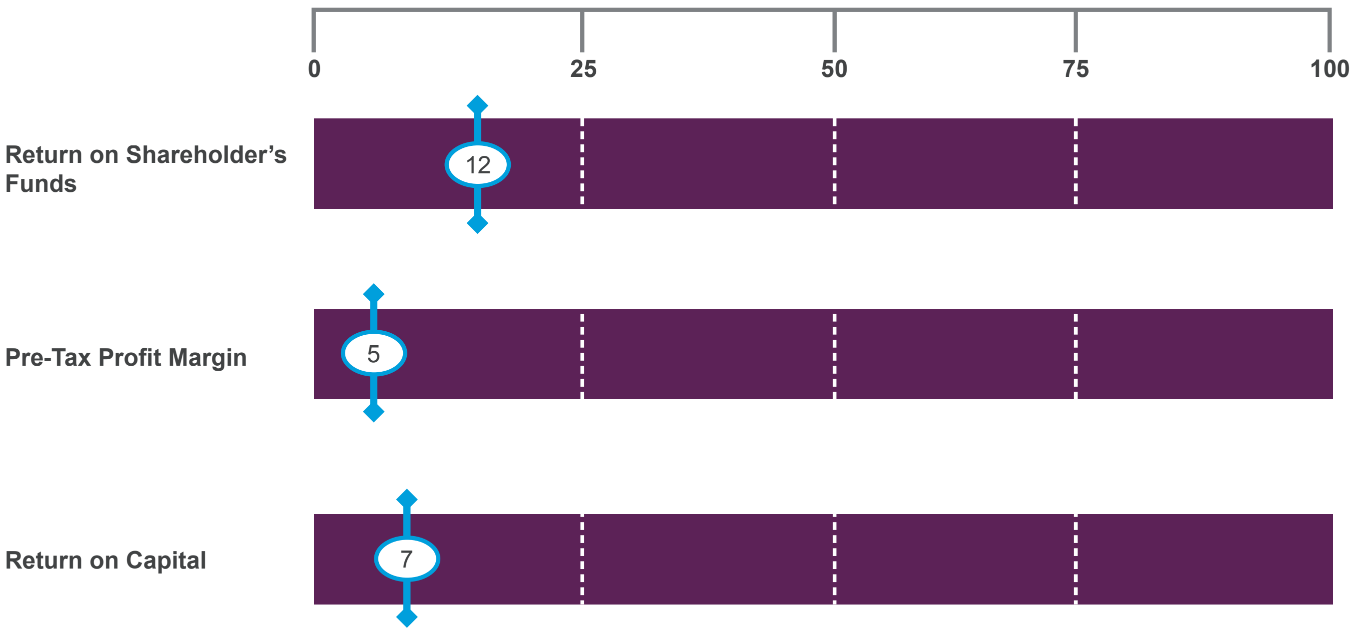
The second component of Clarity is a collection of four financial performance ratios each of which are linked to the **forward-looking indicators** and the **insolvency propensity model**. This includes:

- **Leverage:** a measure of indebtedness but measured in a variety of ways to account for sectoral differences. Our analysis focuses on four distinct measures of leverage to account for sectoral variation in the use of debt;
- **Profitability:** more profitable companies typically utilise their assets more efficiently than lower profitability companies but this again turns on sectoral specificities;
- **Efficiency:** an expression of the relationship between a company's profit and its total assets. The more efficient a company is, the higher its return on assets (as one measure of efficiency);
- **Liquidity:** a measure of a company's ability to service short term debt obligations of no more than 12 months. A current ratio of less than around 1.0 means that total current liabilities exceed total current assets creating potential negative working capital over time.

For example, the chart below shows the median values of three key measures of profitability for all UK SMEs across all sectors. Whilst we can see that at an aggregate level, UK SMEs have a Return on Shareholder's Funds Ratio of 12, a Pre-Tax Profit Margin Ratio of 5 and a Return on Capital Ratio of 7, what has been harder to establish until now is how a given SME fares against a cohort of similar SMEs operating in the same sector in the same region. With this knowledge, in combination with the insights from the other two components of Clarity, we can begin to build a holistic understanding of the health of any given SME to predict whether it faces risk of failure or whether it is a potential growth champion.

Clarity can help identify regional and sectoral outperformance and underperformance when compared to UK medians

UK SMEs Profitability Ratios February 2022, Median %



Source: Quantuma Clarity

> *"The fundamental shift in buyer behaviour and channel preference is likely to endure, resulting in an 'adapt or die' choice facing many thousands of the UK's SME business owners."*

Insolvency propensity model

The third component of Clarity is an **insolvency propensity model**. This model allows us to early identify three very challenged segments of the UK SME population with a focus on mid-market firms with total assets between £0.5-40m. Each of these segments is categorised according to their insolvency risk, which ranges from 4-25 times greater than the 1% observed average insolvency rate for all mid-market SMEs in the UK.

- The first segment is those SMEs that have an insolvency risk of between 4 and 8 times more likely. These SMEs account for the largest share of the total challenged population.
- The second segment is those SMEs that have an insolvency risk of between 8 to 15 times more likely.
- Followed by those with an insolvency risk of between 15 and 25 times more likely.

The chart below shows the four-month evolution of these challenged SMEs from September through to January 2022. There was significant movement in October driven largely by an increase in the number of companies in the 4-8% segment compared to other months.

There was also a significant reduction in companies within the 15-25% segment from October to November. Crucially, there was a very significant increase in companies in the 15-25% bucket from December 2021 to January 2022. Our analysis suggests that the principal driver for the material increase in 15-25% is the significant balance sheet impact of debt servicing for CBLS/BBLS facilities extended during 2020.

Dramatic increases in January 2022 were driven by a significant spike in the most distressed bucket due to CBILS/BBLS obligations bearing down heavily on working capital

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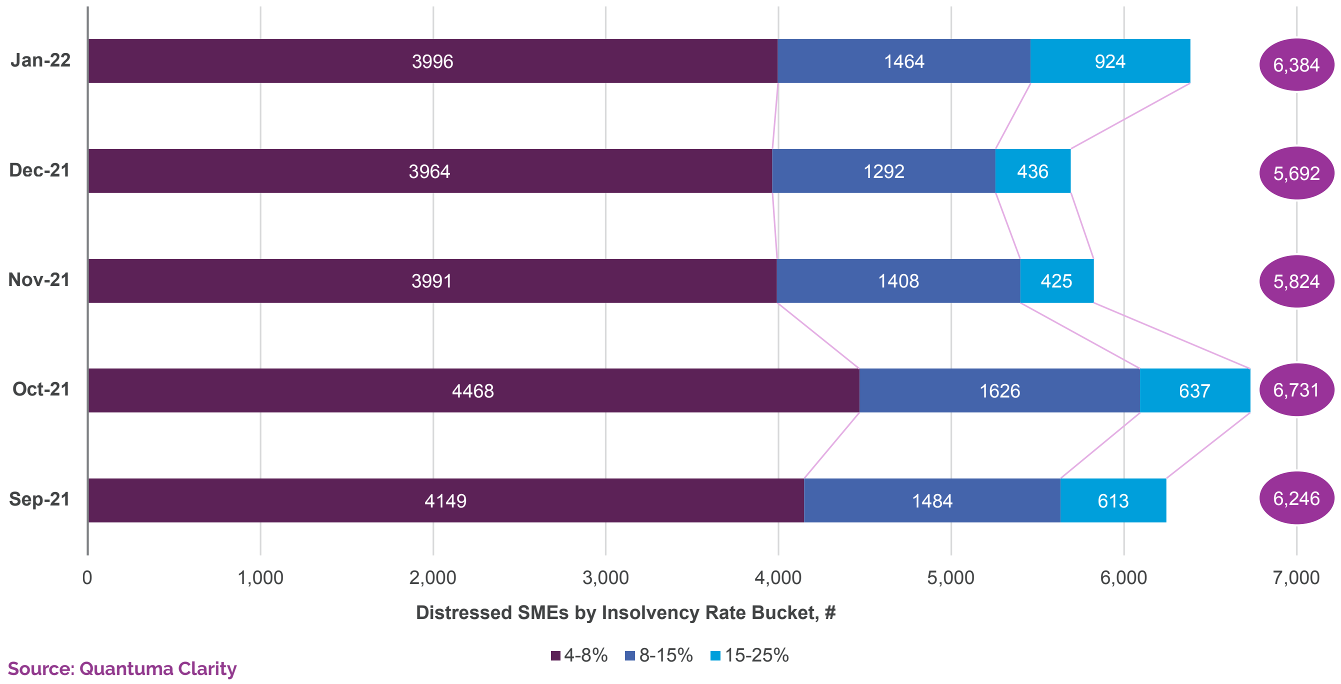
SME Distress by Insolvency Rate Evolution, Sep 2021-Jan 2022



Source: Quantuma Clarity

The drivers of distress and growth

Clarity is equally interested in the drivers of both distress and growth. As demonstrated in the chart below, not all sectors appear equally capable of producing growth champions. Few sectors have a Growth Score higher than the median of 50.5, with the manufacturing[7] sector, perhaps unexpectedly, being one of the major outliers with a Growth Score of 75.

What we really want to know is whether the status quo will remain beyond the post-pandemic recovery, or simply be a by-product of Brexit and Covid-19 and whether, over time, the pattern will revert to the mean. And, of course, there are now other major world events such as the war in Ukraine which may prolong these trends or create a new dynamic that will drive out a different set of winners and losers.

Throughout this programme, we will be looking to identify the hallmarks of growth champions to better understand whether they are equally represented across the UK, or whether they are more concentrated in some regions than others. Do growth champions share several common characteristics independent of region and sector? If so, what are they, and how can we ensure that they receive the right support at the right time? Similarly, are patterns of distress consistent across the UK or do some regions have a higher share of distressed SMEs compared to the UK average?

In asking these and other related questions, we hope that with the insight provided by Clarity, we can empower those in the adviser and lender communities to prevent unnecessary SME failures through timely interventions to ensure their viability and scale-up strategies for the growth champions of the future.

Manufacturing is significantly outperforming other private sectors in terms of growth potential

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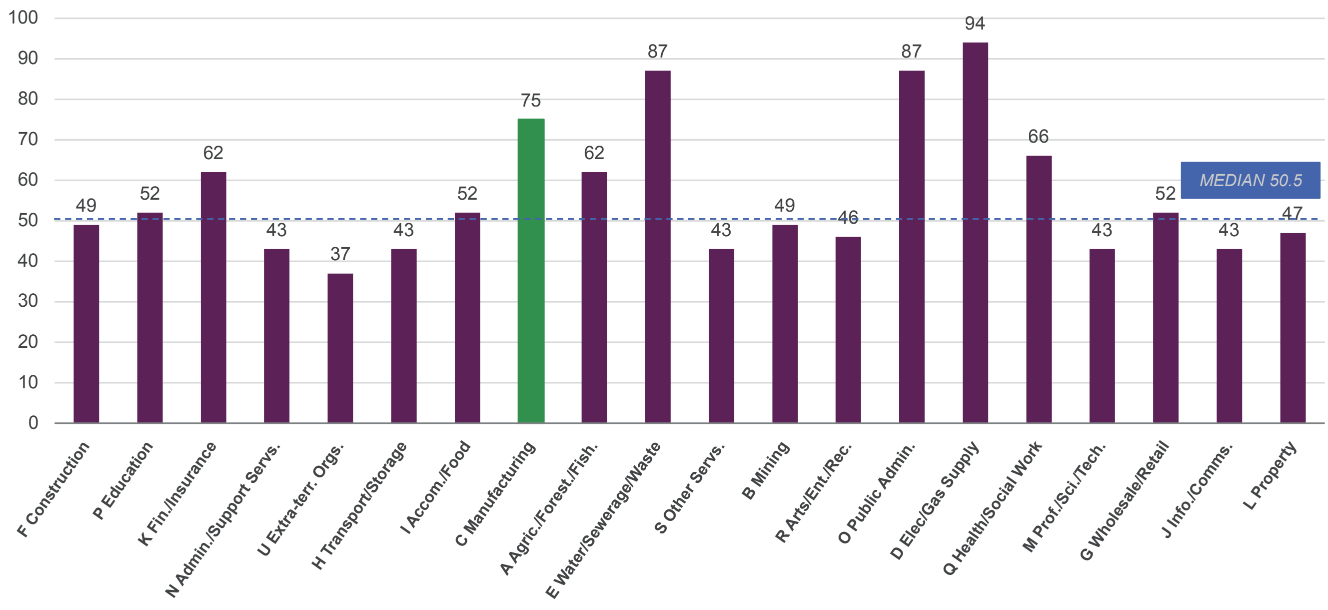
Growth Score (GS), February 2022, 0-100



Source: Quantuma Clarity

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[7]Includes a wide range of manufacturing activities such as food and beverage, textiles, chemicals, pharmaceuticals, metals, computers and electronic components, machinery, vehicles and transport equipment, furniture, medtech, instruments, etc

Section 2

The outlook for the uneven recovery

Carl Jackson
CEO

Marie Wadeson
Managing Director

Key takeaways

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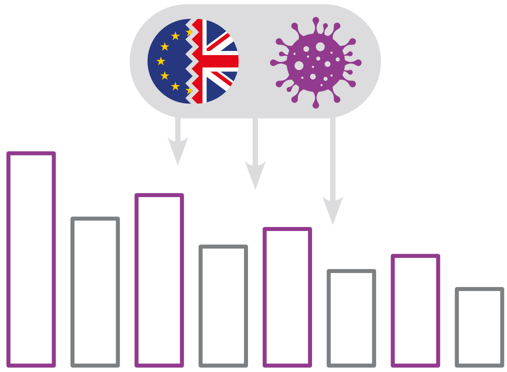
We've summarised the key takeaways and points for this section of the report here.

Twin forces of Brexit and Covid



The **twin forces** of **Brexit** and **Covid-19** exacerbated by the cost-of-living crisis are conspiring to **create challenging trading conditions** for most, but not all, SMEs

Insolvency rates up 11%

Corporate insolvencies increased **11%** to just over **14,000 in 2021** from **12,500 in 2020** despite extensive government support measures and will exceed pre-pandemic levels by 2023

Covid winners and losers will emerge

When **drilling down** into sectors we can see **'covid winners'** and **'covid losers'** emerge, but will the same players retain their positions as recovery takes hold?

Over 500,000 UK employees face a risk of job loss that is between **4-25 times** greater than the UK average

Over 500,000 UK jobs at risk

Outperformance in the South West and underperformance in London

Whilst levels of **distress** amongst SMEs appears broadly consistent across regions there are pockets of **Growth** and **Financial Stability** outperformance in the **South West** and pockets of **Growth** underperformance in **London**

The road to recovery is potholed given Brexit, Covid-19 and Ukraine

Any discussion of a broad-based post-pandemic UK wide recovery ignores the often-divergent fortunes of different sectors and different regions. These differences have become more pronounced during the past two years, resulting in an inconsistent policy approach that seems to have inadvertently given a competitive advantage to those companies in and around London and the South East. Whether the government's flagship levelling-up agenda will realise its lofty ambitions only time will tell, but what we do know is that the 5.6 million SMEs that collectively employ around 16 million people, will play a pivotal role in powering the UK through the post-pandemic recovery.

There is a very real and present risk to any recovery given the impact of Brexit, Covid-19 and the situation in Ukraine, on an acceleration of corporate insolvencies leading to elevated risk of job loss to over 500,000 SME employees - as modelled by Clarity.

SMEs with 20-49 employees are the single largest segment of combined SME turnover of £2.4bn

UK SMEs by Size Bucket, Number of SMEs and Turnover, 2021

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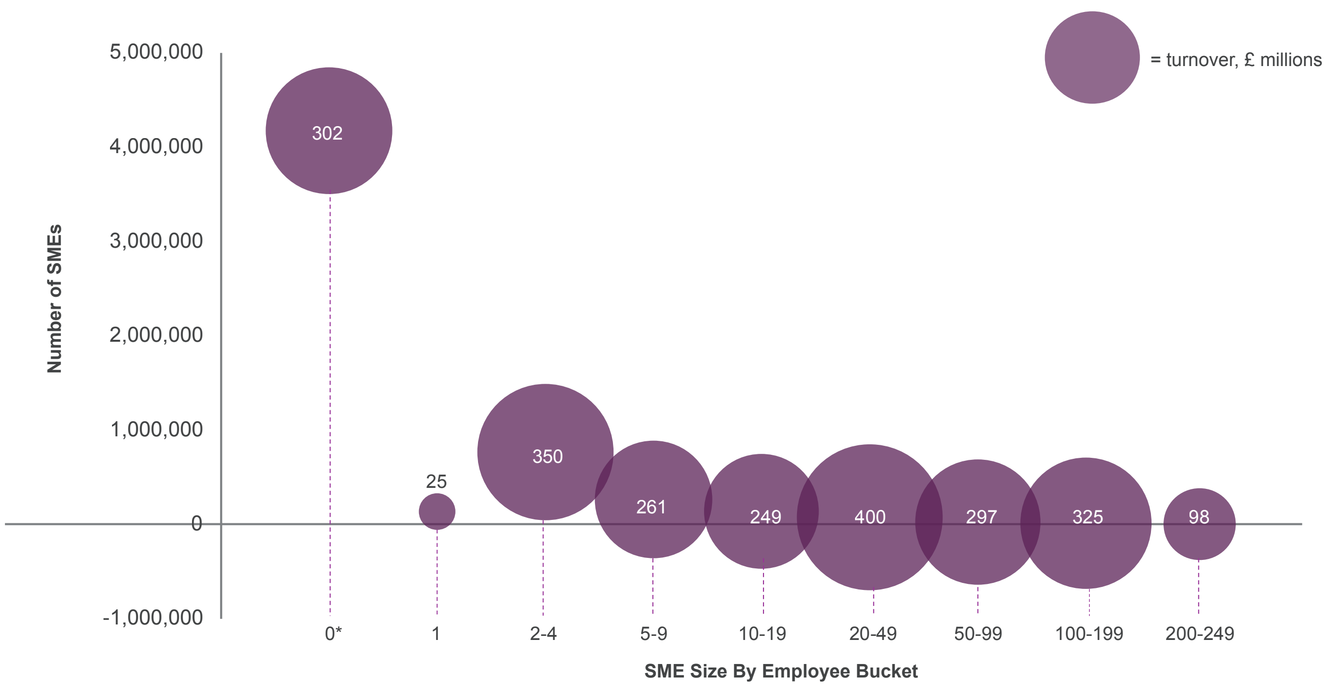


Source: BEIS, Quantuma Clarity

*Note: this category of SMEs have no registered employees

However, with early engagement and strategic intervention, there is no reason why we cannot secure the viability of SMEs that may otherwise fail, whilst at the same time, providing much needed scale-up support to growth champions of the future.

> *"There is a very real and present risk to any recovery given the impact of Brexit, Covid-19 and the situation in Ukraine, on an acceleration of corporate insolvencies leading to elevated risk of job loss to over 500,000 SME employees."*

Setting the scene: is talk of recovery premature?

The twin forces of Brexit and Covid-19 exacerbated by the cost-of-living crisis are conspiring to create challenging trading conditions for most, but not all, SMEs.

Headline data show rising inflation and tightening monetary policy, while expectations are that the recent modest decline in unemployment will soon go into reverse. This time last year, debt-fueled stimulus was injected into the economy to prop up the ailing SMEs sector, and commentators were pointing to the need for a loosening of monetary and fiscal policy to support growth. However, global supply-chain constraints and the recent surge in wholesale energy prices has sent inflation well past the Bank of England's 2.0% target; the Bank now expects inflation to peak at around 7% in April and to fall back only gradually, not returning to 2% until around 2024.

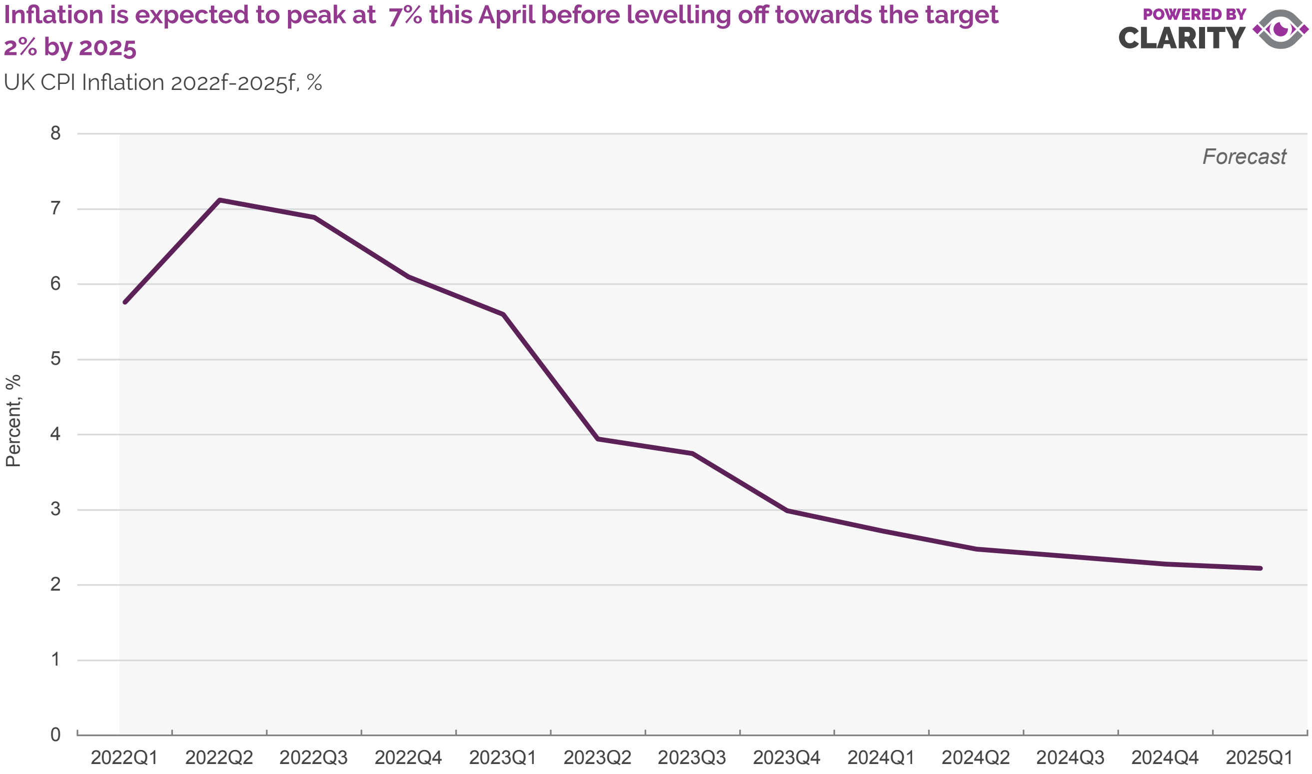
Whilst the Chancellor has yet again extended financial support to those SMEs most affected by Covid-19, any discussion of a broad-based UK wide recovery ignores the wildly divergent impact the twin forces of Brexit and Covid-19 have had on different sectors and regions.

Demand is clearly outstripping supply in some narrow aspects of the economy (professional services being one of the most often cited examples) but lagging in many others especially hospitality, tourism, and leisure sectors.

The implications for this unequal impact are clear. There is no 'one-size-fits all' strategy for helping navigate SMEs through these troubled times. Instead, we strongly believe that each SME's needs should be considered with respect to sectoral and regional specificities. Those SMEs reliant on extensive foreign supply chains will face working capital challenges as higher input prices feed into suppressed margins, whereas those SMEs where 'human capital' is the main 'commodity,' are likely to be faced with staff shortages acting as a constraint on growth.

Inflation is expected to peak at 7% this April before levelling off towards the target 2% by 2025

UK CPI Inflation 2022f-2025f, %



Source: BoE, MPR February

As revealed in the most recent Bank of England Decision Makers Panel survey, respondents suggest that the negative effects of the pandemic are likely to have fully reversed during 2023, with investment sentiment having accelerated during Q4 2021 in response to the continued reopening of the economy and easing of lockdown restrictions. However, it remains to be seen whether, considering the Ukraine situation, the same optimism holds true given the likely effect on input prices and further upside pressure on wholesale energy prices leading to further inflationary pressure.

Brexit will cost UK households between £1,500-5,000 and impact GDP by between 3%-8%

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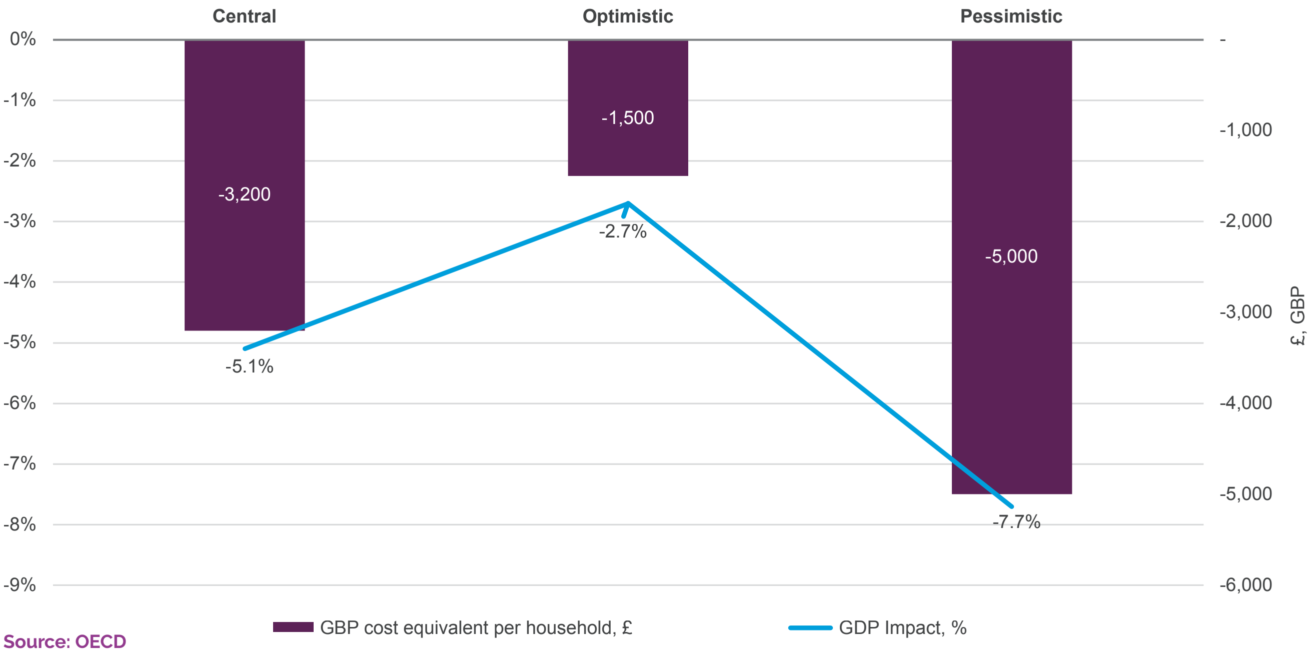
2030 Impact of Brexit on UK GDP and Households



Source: OECD

> *We strongly believe that each SME's needs should be considered with respect to sectoral and regional specificities.*

Individually, each of these forces would have left a marked but temporary impact on the shape and scale of the UK economy. However, taken together, the impact is more profound and will likely lead to a fundamental economic adjustment affecting some sectors and regions more profoundly than others.

Sales, employment and investment impact of covid on UK businesses will wane led by an acceleration in invesment likely to outpace pre-pandemic levels during 2023

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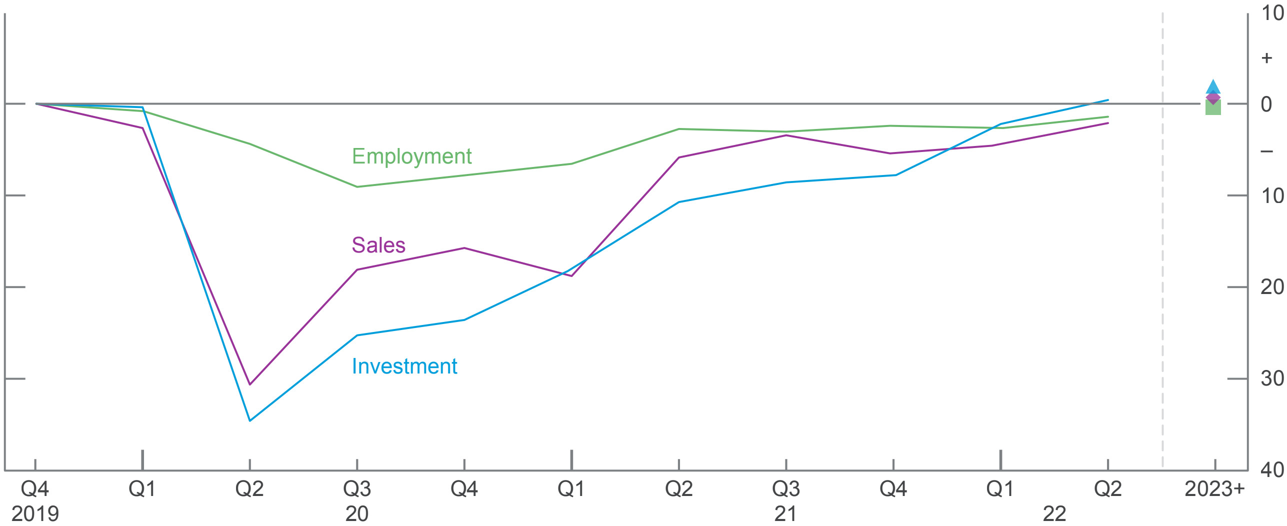
Covid-19 Impact on UK Business Employment, Sales, Investment, Q4 2021



Source: BoE DMP Survey

Export-led businesses have been forced in many cases to re-write or abandon old operating models considering severe supply chain challenges and substantially increased import costs which have been reduced to below zero already paper-thin margins for fast-moving retail goods businesses for instance.

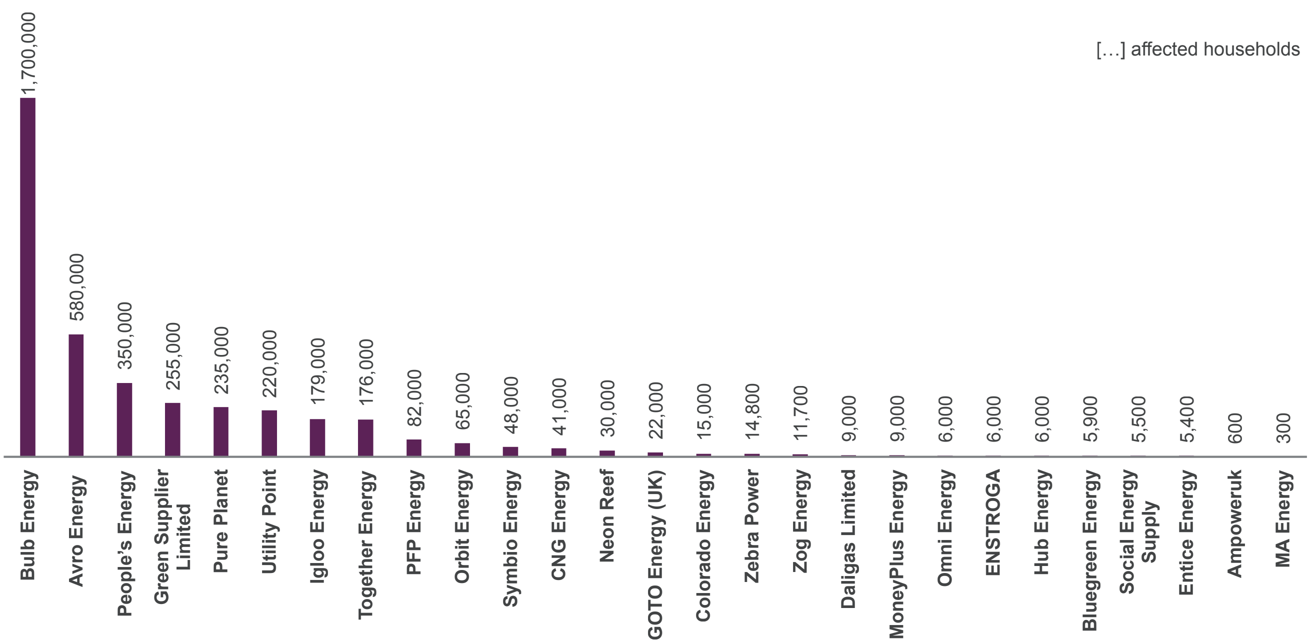
Hopes of recovery are pinned on consumption, but accumulated household savings are likely to be run down quicker than expected given inflation and cost of living increases largely driven by significant increases in wholesale energy prices, which have already led to the collapse of over 25 UK energy companies since August 2021.

The collapse of these firms came as no huge surprise to us based on signals from Clarity. Shake-out within the new to market utility segment was inevitable following the surge in wholesale energy prices. Many newer players' business models were heavily dependent on very low wholesale prices. Consequently, they had very low levels of operational resilience built into them compared to more established players.

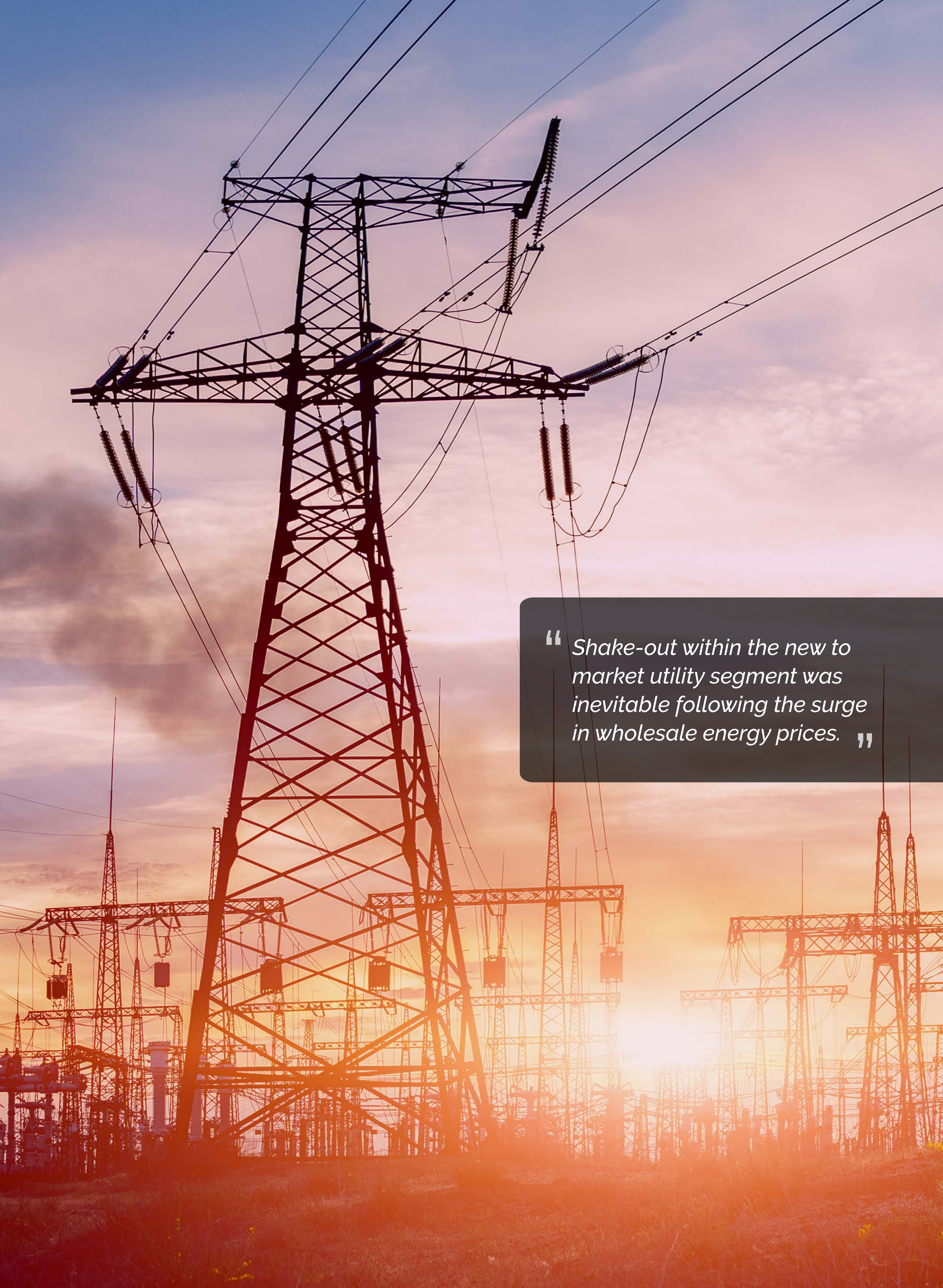
> *"We expect that in 2022 total insolvencies will reach 2019 levels with a 20% increase over 2021 and will reach around 19,000 by 2024."*

Over 4m UK households have been affected following the failure of 27 energy firms

Collapsed UK Energy Firms and Households Affected Since August 2021



Source: OFGEM, Quantuma analysis



> *"Shake-out within the new to market utility segment was inevitable following the surge in wholesale energy prices."*

Insolvency rates set to normalise

Corporate insolvencies increased 11% to 14,048 from 12,635 in 2020[8] despite extensive Treasury support measures and they remain below pre-pandemic levels - but for how much longer?

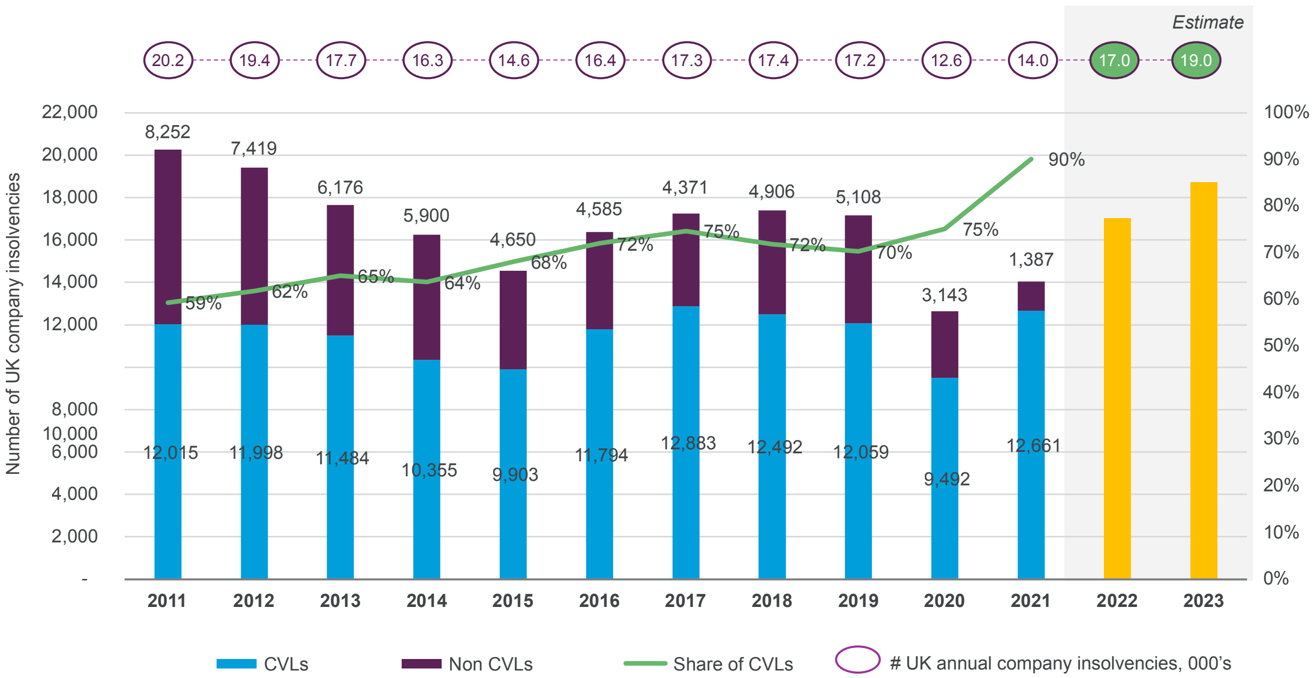
The widely anticipated raft of corporate insolvencies did not materialise during 2021 and with good reason; the government injected over £80bn into UK businesses through various forms of business support including from lending schemes, business rates holidays, tax deferrals and VAT reductions. This support has allowed businesses to 'tread water' for the time being. But fundamental structural change in market conditions and supply chains, driven by Brexit and compounded by Covid-19, have meant many small businesses are simply no longer viable.

We expect that in 2022 total insolvencies will reach 2019 levels with a 20% increase over 2021 and will reach around 19,000 by 2024. This will be driven in part by a sharp acceleration of insolvencies coming into Q3 and Q4 this year as inflationary pressures, the cost-of-living crisis, and fallout from the Ukraine situation weigh heavily on the micro-end of the market and particularly owner-managed businesses.

Whilst there is an expected level of inertia amongst tightly held owner-managed businesses, where there is much stronger emotional connection to the business, owners are now much more receptive to exploring the 'art of the possible' when thinking about topics that previously had been 'off the table'. They include succession planning, full and partial exits, and, introducing debt into the capital structure for instance. One trend we are observing is the increase in the use of employee ownership trusts (EOTs) as a vehicle for exit for owners.

CVLs now constitute 90% of all insolvencies representing a 15% increase in 2020 with total insolvencies estimated to exceed pre-pandemic levels in 2023

UK Company Insolvencies and Relative Share of CVLs , 2011-2021



Source: Insolvency Service, Quantuma Clarity

[8]The Association of Business Recovery Professionals, "R3"

Winners and losers: a sector view

When drilling down into sectors a very different picture emerges, with both winners and losers - but will the same players retain their positions as recovery takes hold?

It is widely understood that Covid-19 and the consequent injection of stimulus from the Treasury had an uneven effect on regions and sectors. But will those that had a 'good pandemic' be well positioned to power through the recovery, or will those that had a 'bad pandemic' have their fortunes reversed?

SMEs in the utilities sector have the highest **Growth Score** in the UK and with a median score of 94, sitting comfortably above the UK median of 50.5. This has been driven in part by growth in the renewables market and despite the high profile failures in the sector in recent times. Conversely, we can also see that several sectors are significantly trailing the UK median with a score of 43. Perhaps counter-intuitively given the demand for goods bought online and delivered due to the many months of lockdown restrictions, SMEs in the transport sector within SIC divisions 49, 50 , 51 , 52 , 53 also score 43. However, increased demand for goods transport has been offset by reductions in passenger numbers across rail and air channels.

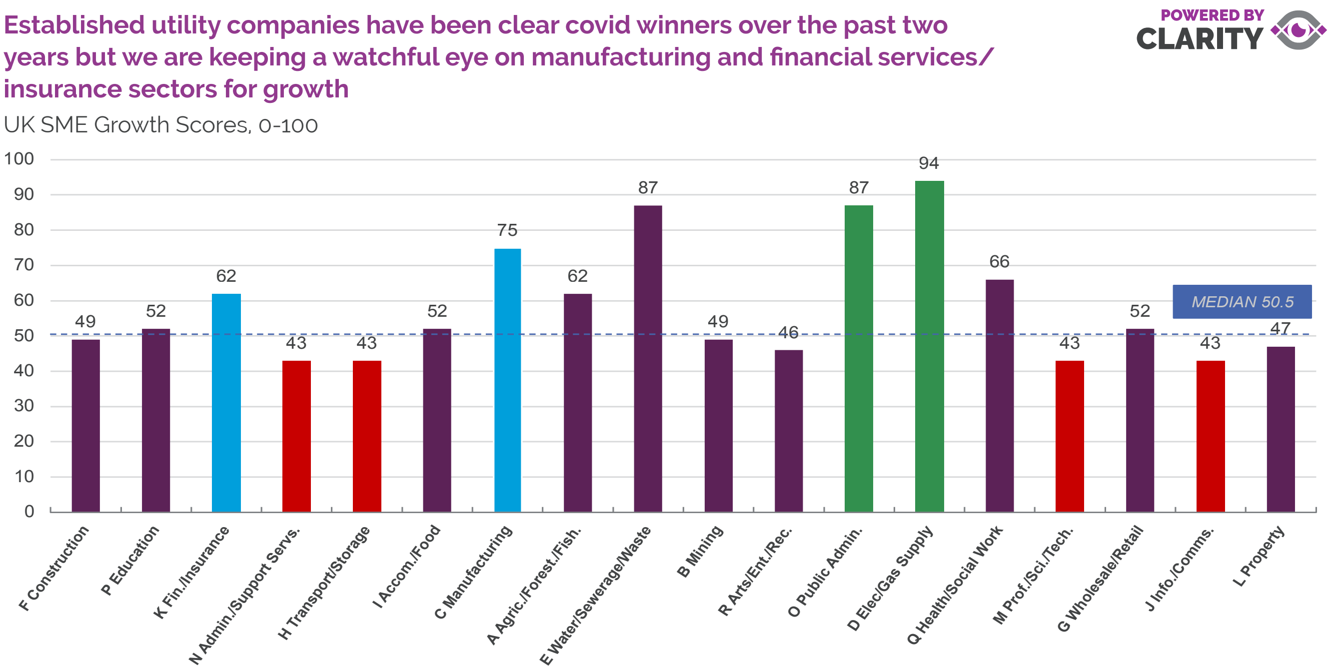
Utilities (established players not new to market players) will continue to enjoy relative outperformance during this year, along with other SMEs funded by the public purse including those that fall under the public administration sector, which has a Growth Score of 87. However, we expect a gradual reversion to the mean as the effects of central government stimulus are fully phased in and as the private sector takes advantage of the full reopening of the economy and withdrawal of the last remaining Covid-19 measures during late February.

> *"We maintain a watchful eye on SMEs in the manufacturing and financial services/insurance sectors where Clarity is identifying an increasingly stronger pattern of growth signals."*

We do not expect to be ushering in a new era of growth champions in the utilities sector. Instead, we maintain a watchful eye on SMEs in the manufacturing and financial services/insurance sectors where Clarity is identifying an increasingly stronger pattern of growth signals which will intensify as the economy continues to 'open up' despite the challenging macro-economic backdrop.

Established utility companies have been clear covid winners over the past two years but we are keeping a watchful eye on manufacturing and financial services/ insurance sectors for growth

UK SME Growth Scores, 0-100



Source: Quantuma Clarity

Winners and losers: a regional view

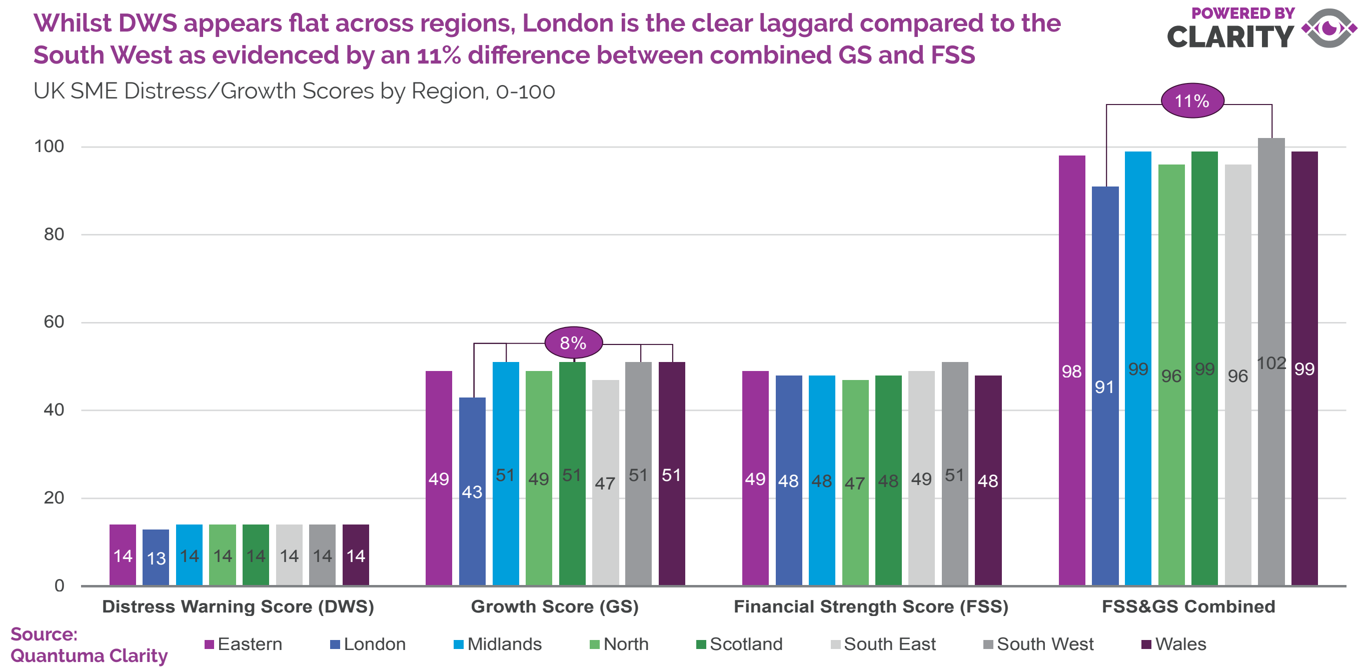
Whilst the level of distress appears broadly consistent across regions, we are seeing pockets of growth and financial stability outperformance in the South West and pockets of growth underperformance in London.

Since 2020, received wisdom is that regional location is not a key driver of the success or failure of an SME. However, our analysis reveals that differences do exist between regions and that some of these differences run counter to recently introduced policy measures as part of the levelling-up agenda. When drilling into each of the regions, a stark picture emerges of the variance when looking at measures of distress **(DWS)**, financial strength **(FSS)** and growth **(GS)** as captured by Clarity.

London, with a score of 43, is lagging regional leaders Midlands, Scotland, South West, and Wales in terms of growth each scoring 51. Whilst the capital's GS score performance may surprise some, it was entirely consistent with our expectations given the very dynamic nature of the London labour market and the high concentration of sectors that are very sensitive to the free movement of people and the consequent negative affect of Brexit leading to repatriation of many of the capital's skilled workers employed in hospitality, leisure, food & beverage, and accommodation SMEs for example. Conversely, with respect to FSS, the South West is leading the pack with a score of 51 closely followed by Eastern and South East with scores of 49 each respectively followed by Scotland, London, Midlands and Wales with a scores of 48 each respectively.

Whilst DWS appears flat across regions, London is the clear laggard compared to the South West as evidenced by an 11% difference between combined GS and FSS

UK SME Distress/Growth Scores by Region, 0-100



Source: Quantuma Clarity

Glossary of terms

Distress Warning Score (DWS):
a blended score from 0-20 (where 20 is best) trained to identify SMEs that are likely to default over the next three to six months. It combines credit information with invoice settlement delinquency (see DBT below) and County Court Judgements, producing a score that helps identify businesses that are in distress and potentially at risk of failing within the short to medium term

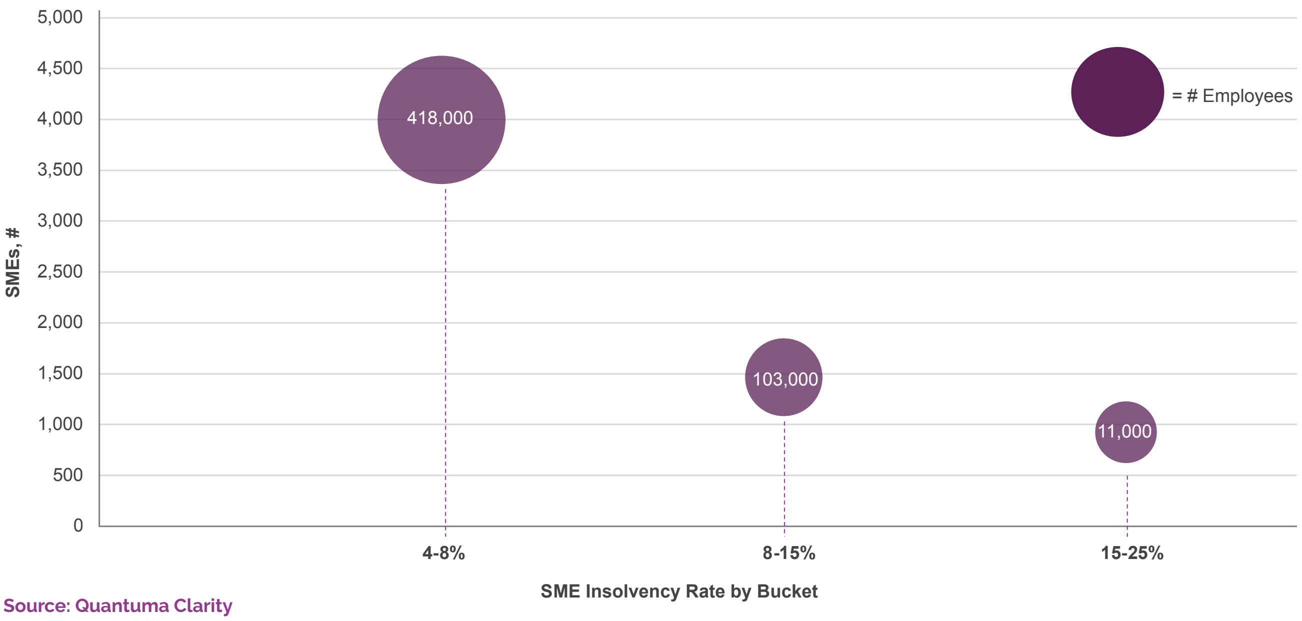
Financial Strength Score (FSS):
a measure of financial viability from 0-100 (where 100 is best) trained to look for insolvency (liquidation, receivership, and administration) over a 12-month horizon using filings history, financial information, corporate and organisational data and other leading indicators

Growth Score (GS):
a measure of growth from 0-100 (where 100 is best) influenced by historic and forecast YoY turnover growth and YoY employee growth

As introduced in our Foreword, a key component of Clarity is a proprietary insolvency propensity model that allows us to early identify the most severely challenged mid-market UK SMEs that have an insolvency risk that is between 4-25 times the national average of 1%. Using this model, we have identified a population of the UK labour force that faces a risk of job loss that is between 4-25 times greater than the UK average.

Over 500,000 UK employees face a 4-25 times greater risk of job loss compared to the UK average with the number increasing during the course of 2022 into 2023

Employees by Insolvency Risk Bucket, January 2022



Source: Quantuma Clarity

Almost 80% of this cohort is concentrated within the 4-8% insolvency risk bucket comprising roughly 4,000 SMEs, 20% is accounted for in the 8-15% bucket comprising roughly 1,500 SMEs and less than 1% in the 15-25% bucket comprising roughly 1,000 SMEs.

We anticipate levels of distress to increase amongst UK SMEs throughout the year and this will feed into an increasing number of corporate insolvencies this year and next. However, having early identified the SMEs and their affected employees, preventative measures should be taken now, thereby ensuring the continued viability of these SMEs and the lifeline that they provide the 500,000 employees whose livelihoods can be preserved with acute and timely preventative strategic interventions.

> *"Over 500,000 UK employees face a risk of job loss that is between 4-25 times greater than the average UK private sector employee."*

Section 3

Comparing the performance of key industry sectors

Carl Jackson
CEO

Marie Wadeson
Managing Director

Key takeaways

We've summarised the key takeaways and points for this section of the report here.

Profound impacts on **leverage** and **profitability**

Lockdown restrictions appear to have **profoundly impacted leverage** and **profitability** within the accommodation / food sector resulting in a **significantly reduced FSS** compared to the UK median and compared to historic averages.

Manufacturers leading the way

Manufacturers are **significantly outperforming** the UK median in terms of **growth**, and we believe that this outperformance is enduring and will **survive** any temporary Covid-19 induced effects.

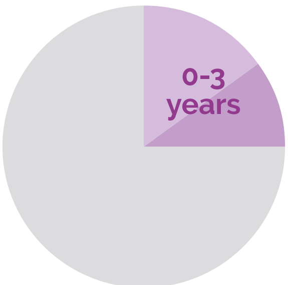
Return on Assets: outperforming sectors **in line** with **expectation**

When using **Return on Assets** as a **measure of efficiency**, the outperforming sectors are **broadly in line with expectation** albeit with some **notable surprises** most notably the **manufacturing sector**.

Variability on **short** and **long term** debt

There is **significant** variability between and within sectors when accounting for both **short- and long-term debt obligations** which speaks to the unique characteristics of each sector and how a '**one size fits all**' approach to considering the suitability of debt financing for SMEs does not work.

Significantly more SMEs aged **0-3 years** in **15-25** insolvency rate bucket



Prevalence of SMEs aged between **0-3 years** is **significantly higher** within the **15-25% insolvency rate** bucket which goes some way to validating the widely held view that those early years are **vital** for SMEs in securing their **long-term future**.

Mining and **education** have highest share of SMEs with a **15-25%** insolvency rate

When looking at the **most challenged segment** of the SME market, it is apparent that the **mining** and **education** sectors have the **highest share** of SMEs with a **15-25% insolvency rate** whereas the **wholesale / retail** sector has the **lowest** blended risk.

The lockdown and its impact on all sectors

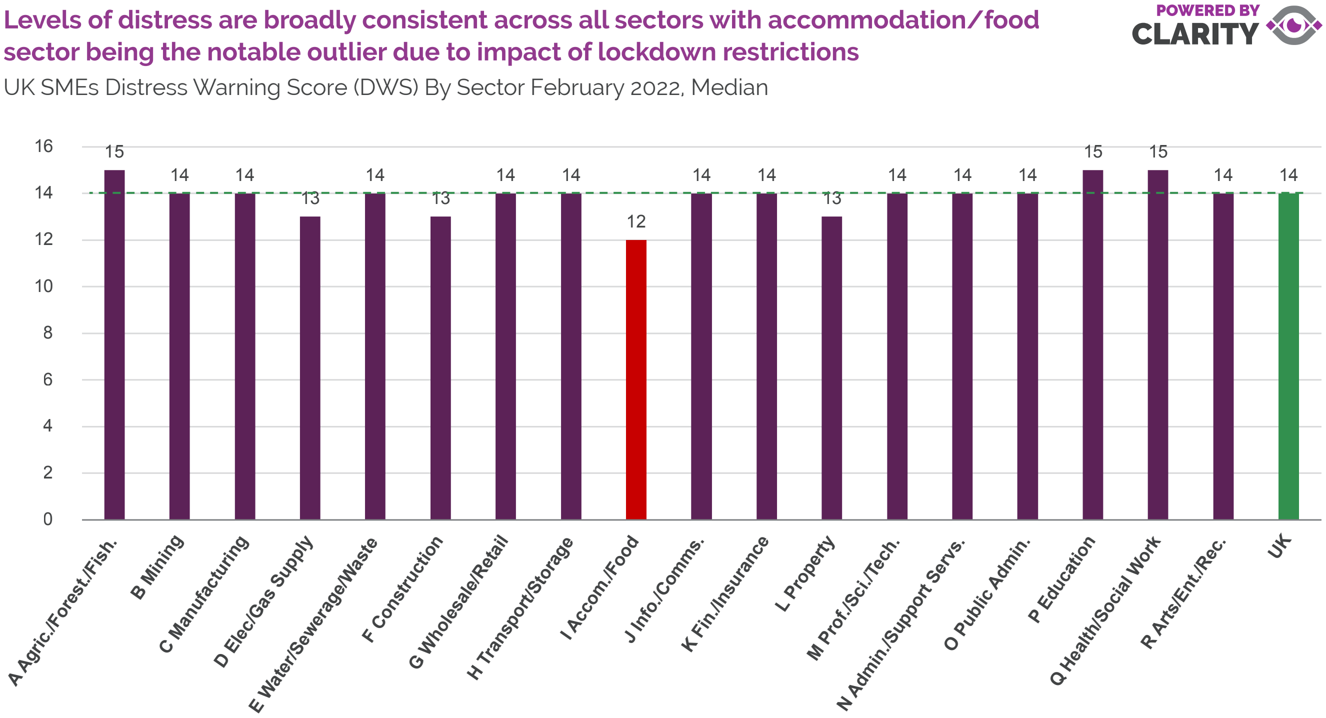
Levels of distress appear broadly consistent across all sectors despite the profound impact of lockdown restrictions on some sectors more than others over the past 24 months.

It comes as no surprise to us that SMEs within the accommodation / food sector, SIC divisions 55[9] and 56[10] appear more distressed than the UK average as measured by the Distress Warning Score (DWS). However, the size of delta has surprised us as we expected the difference to be manifestly larger.

Whilst the sector remains an outlier overall, our analysis has revealed that the indicators feeding into the DWS are not yet picking up key input data compared to the FSS score which is presenting us with data that is more consistent with our assumptions with respect to SMEs in SIC divisions 55[9] and 56[10] as detailed below.

Levels of distress are broadly consistent across all sectors with accommodation/food sector being the notable outlier due to impact of lockdown restrictions

UK SMEs Distress Warning Score (DWS) By Sector February 2022, Median



Source: Quantuma Clarity

[9]Includes hotels, short-stay accommodation, camping grounds
[10]Includes restaurants and take-aways, event caterers, pubs and clubs

The impact on leverage and profitability

Lockdown restrictions appear to have profoundly impacted leverage and profitability within the accommodation/food sector resulting in a significantly reduced FSS compared to the UK median and compared to historic averages.

In contrast to the DWS, results using the FSS suggest a dramatically different outlook for SMEs active within SIC divisions 55 and 56 that have a score of 16 compared to the UK median of 49 – the delta is much higher in the case of FSS compared to DWS for SMEs in SIC divisions 55 and 56.

Based on closer examination of the SMEs financial position, our analysis reveals elevated levels of indebtedness and far lower levels of profitability both of which are bearing down very heavily on key financial ratios that drive FSS performance. Cash reserves have been run down as they trade under significant working capital pressure. Our analysis suggests that they will continue to remain challenged this year and our expectation is that their FSS will not materially improve and may in fact worsen as we approach Q4.

For the same reasons that SMEs in the Accommodation/Food sector have come under significant pressure, SMEs active in Public Administration, Health/Social Work have improved their standing in the past two years compared to historic averages.

Interestingly, SMEs in the Agriculture/Forestry/Fishing sector in SIC divisions 01, 02 , 03 are the standout private-sector performers with an FSS that is significantly outpacing the UK median of 49. Our analysis suggests that this is largely driven by a significant increase in retail prices which have in turn fed into improved margins for many food producers.

Unsurprisingly the accommodation/food sector is the most challenged from a viability perspective with most private sector companies broadly in line with the UK median

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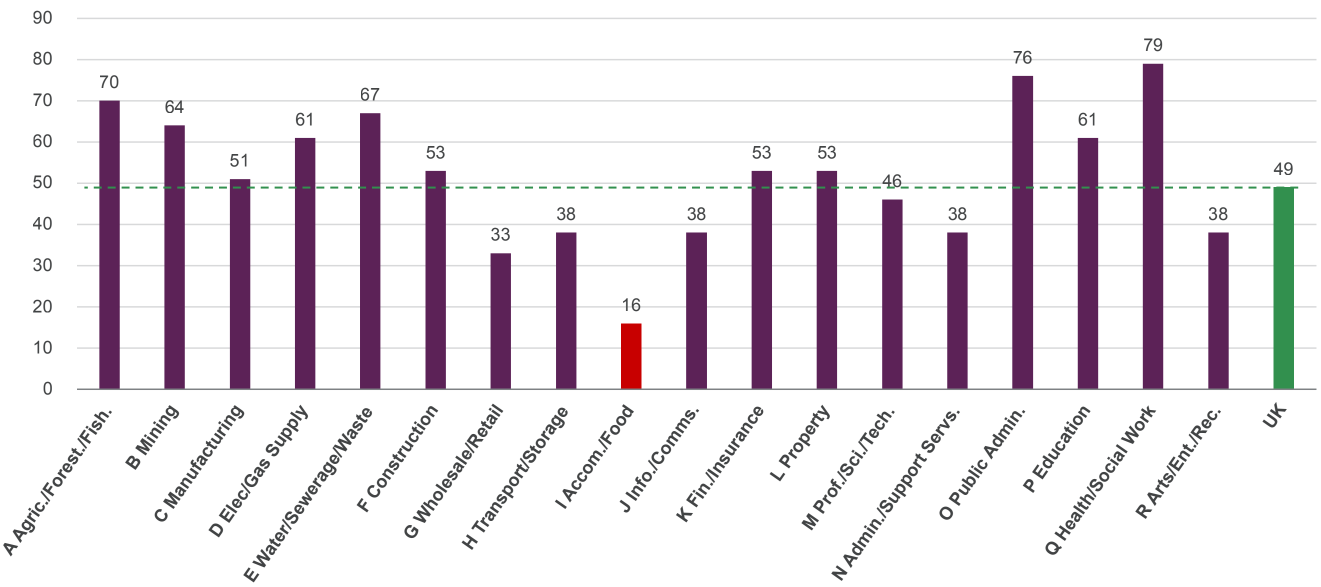
UK SMEs Financial Strength Score (FSS) By Sector February 2022, Median



Source: Quantuma Clarity

Manufacturers leading the way... for now

Manufacturers are significantly outperforming the UK median in terms of growth, and we believe that this outperformance is enduring and will survive any temporary Covid-19 induced effects.

When accounting for Covid-19 related impacts, we believe that SMEs active in the manufacturing sector - in SIC divisions 10-33 inclusive - are likely to maintain their relative outperformance even when allowing for pandemic-related effects.

Whilst it is too early to draw any firm conclusions from the data emerging from Clarity, we are seeing early indications of higher than historic levels of capital investment suggesting that confidence is growing within the sector. This is leading to planned improvements in capacity and productivity to meet anticipated growth in the demand as consumers increasingly orient themselves towards a more 'made in the UK' attitude in the wake of Brexit. However, this needs to be carefully considered. The recently ratified Trade and Cooperation Agreement does not fully replicate EU-UK trading relationships that existed before Brexit and firms now must contend with higher administrative barriers to trade and a constrained labour force that may take some time to heal despite improving sentiment and confidence amongst SMEs.

SMEs active in the utilities and public administration sectors have benefited from the pandemic but manufacturers are the underlying outperformers

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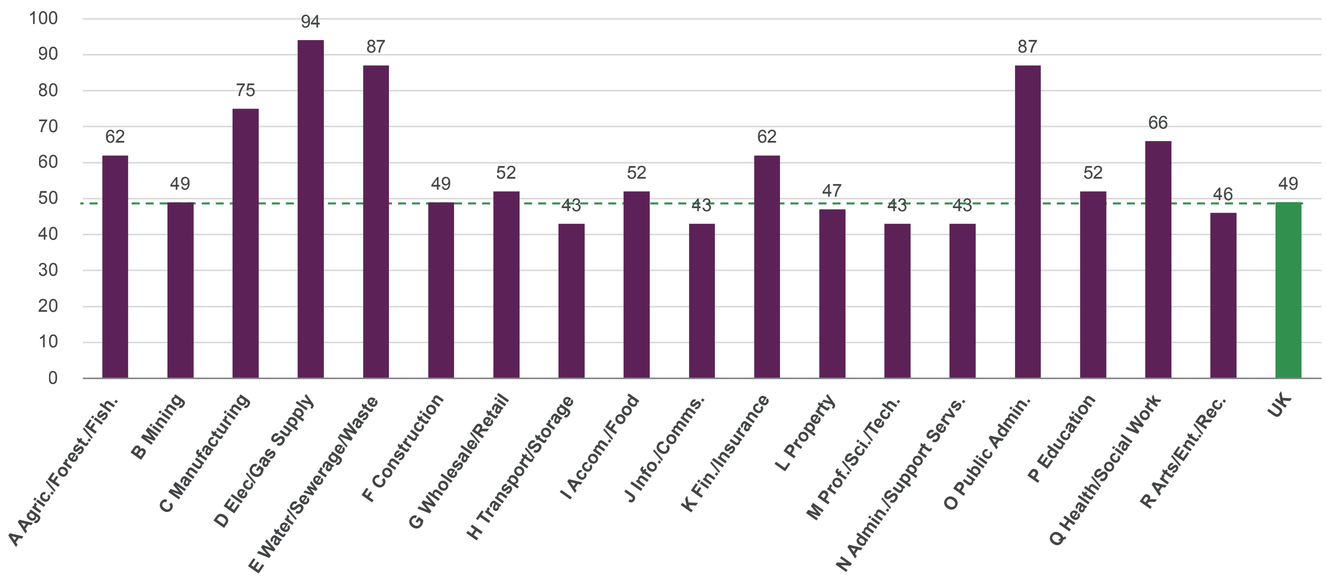
UK SMEs Growth Score (GS) By Sector February 2022, Median



Source: Quantuma Clarity

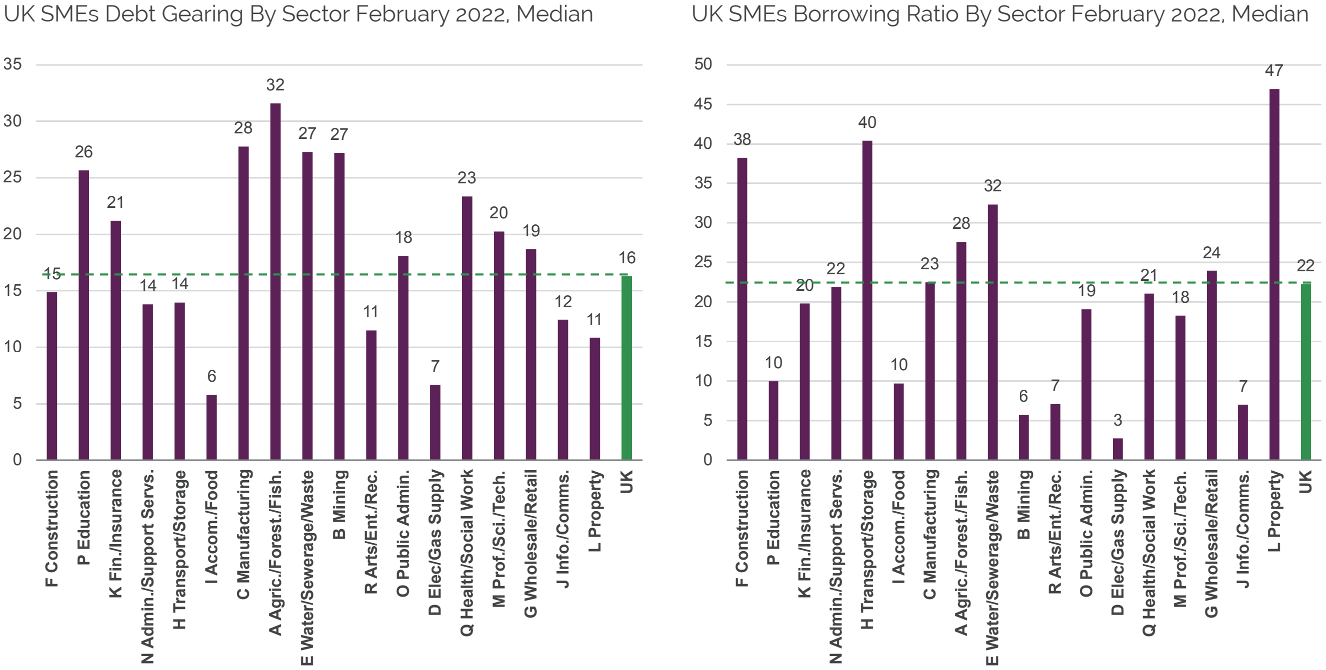
A closer look at leverage

There is a significant difference between - and within sectors - when accounting for both short and long-term debt obligations, highlighting the unique characteristics of each sector and how a 'one size fits all' approach will not work when considering the suitability of debt financing for SMEs.

Clarity has revealed some stark findings when looking at leverage using two very different measures of indebtedness. On the one hand, when considering **obligations of greater than one year** through the Debt Gearing ratio, SMEs in the transport/storage sector appear marginally less levered than the UK median. However, when considering both **short and long-term** , we can see that transport/storage companies have a Borrowing Ratio of almost double the UK median.

Similarly, when looking at SMEs in the mining sector, using Debt Gearing alone would suggest that SMEs are much more levered than the UK median, however, when using the Borrowing Ratio which takes account both short and long-term debt obligations, we see that mining SMEs show far lower levels of leverage compared to the UK median.

Levels of sector leverage relative to the UK median change dramatically when considering either or both short and long-term debt obligations



Source: Quantuma Clarity

Return on assets

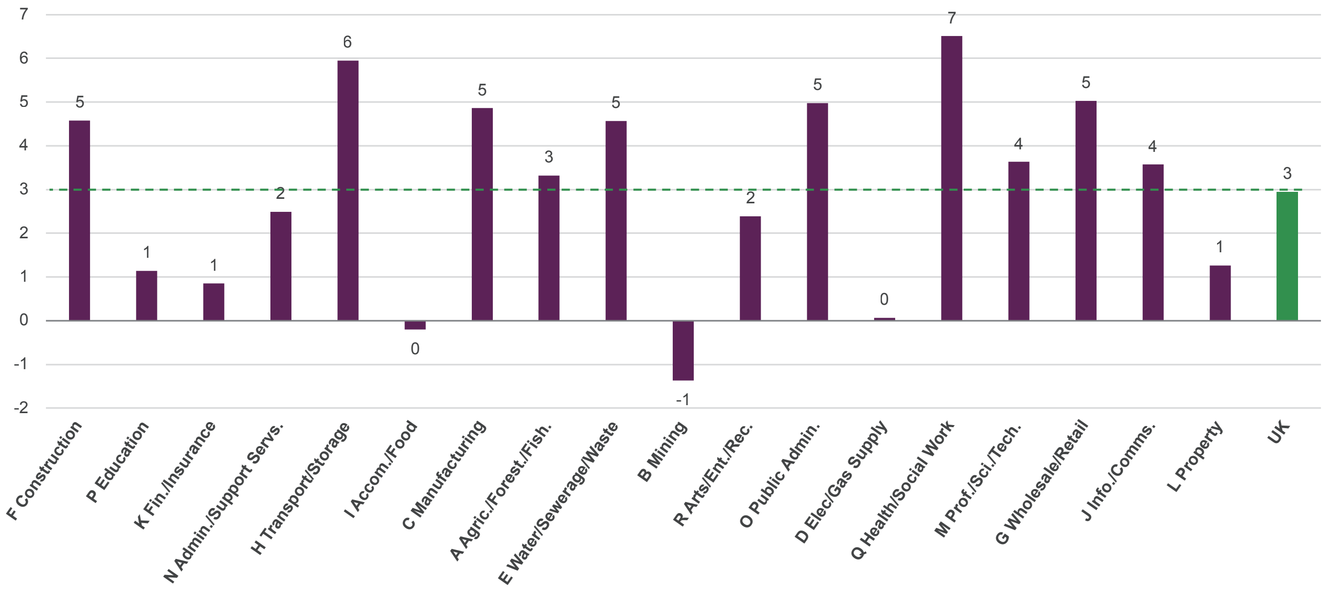
When using Return on Assets as a measure of efficiency, the outperforming sectors are broadly in line with expectation, albeit with some notable surprises most notably the manufacturing sector.

We expect that levels of outperformance of the health/social work and transport/storage sectors will recede over the next 12 months or so in line with reducing levels of profitability. Persistent profitability pressures within the mining sector and a shrinking market continue to weigh heavily on efficiency, resulting in significant underperformance compared to the UK median.

We were surprised to see outperformance in the manufacturing sector given historically low levels of capital investment. Although, as previously detailed, we have observed a recent spike in capital investment brought about by vastly improved sentiment and confidence.

Traditionally more capital-intensive sectors have elevated levels of efficiency compared to other sectors

UK SMEs Return on Assets By Sector February 2022, Median



Source: Quantuma Clarity

“The most striking outperformer is the property sector…whose results have been significantly skewed by the record performance of estate agents.”

Profitability compared to leverage

We can observe broadly consistent patterns within and across sectors when considering distinct measures of profitability compared to measures of leverage.

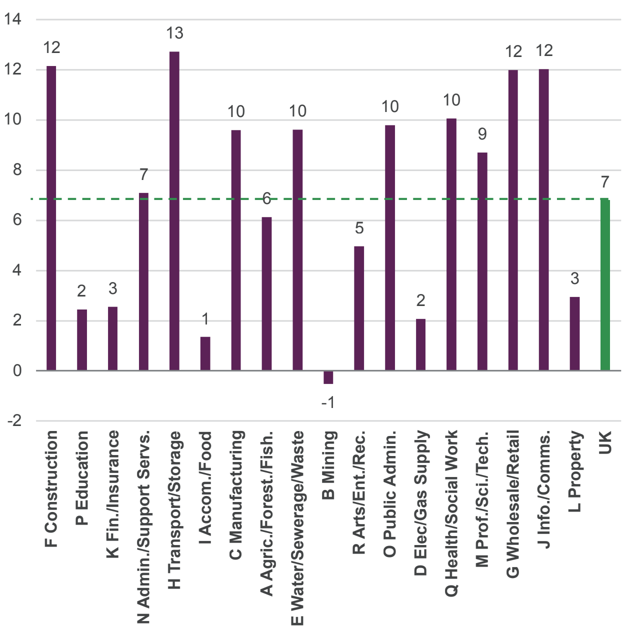
In comparison to the Leverage ratios above, the results within and across sectors when considering two alternative measures of profitability are more consistent. The most striking outperformer is the property sector SIC division 68 whose results have been significantly skewed by the record performance of estate agents, which have benefited from the government's various initiatives to support the housing market during the pandemic.

We expect this outperformance to recede sharply this year - the evidence for this is in plain sight. Estate agents are reporting lower than normal stock levels and as rental markets in the larger cities have softened as renters consider options away from densely populated urban areas in favour of greener surroundings.

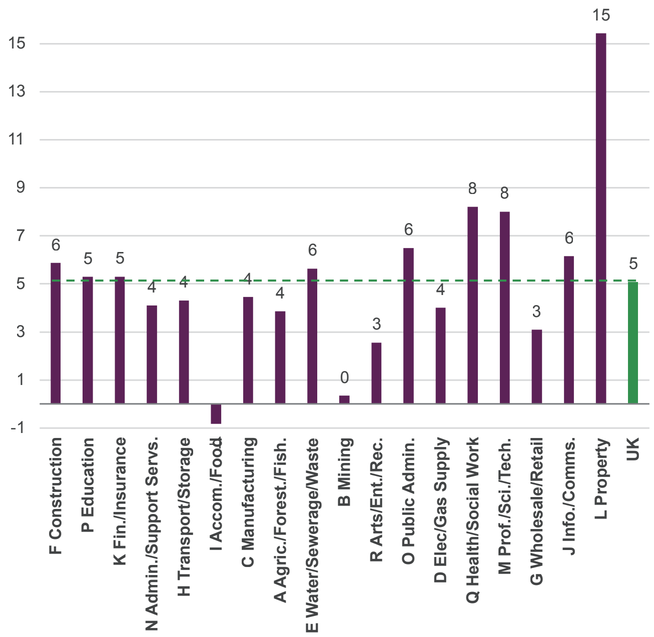
Distinct measures of profitability deliver more consistent results across and within sectors compared to distinct measures of leverage

POWERED BY CLARITY

UK SMEs Return on Capital By Sector February 2022, Median



UK SMEs Pre-Tax Profit Margin By Sector February 2022, Median



Source: Quantuma Clarity

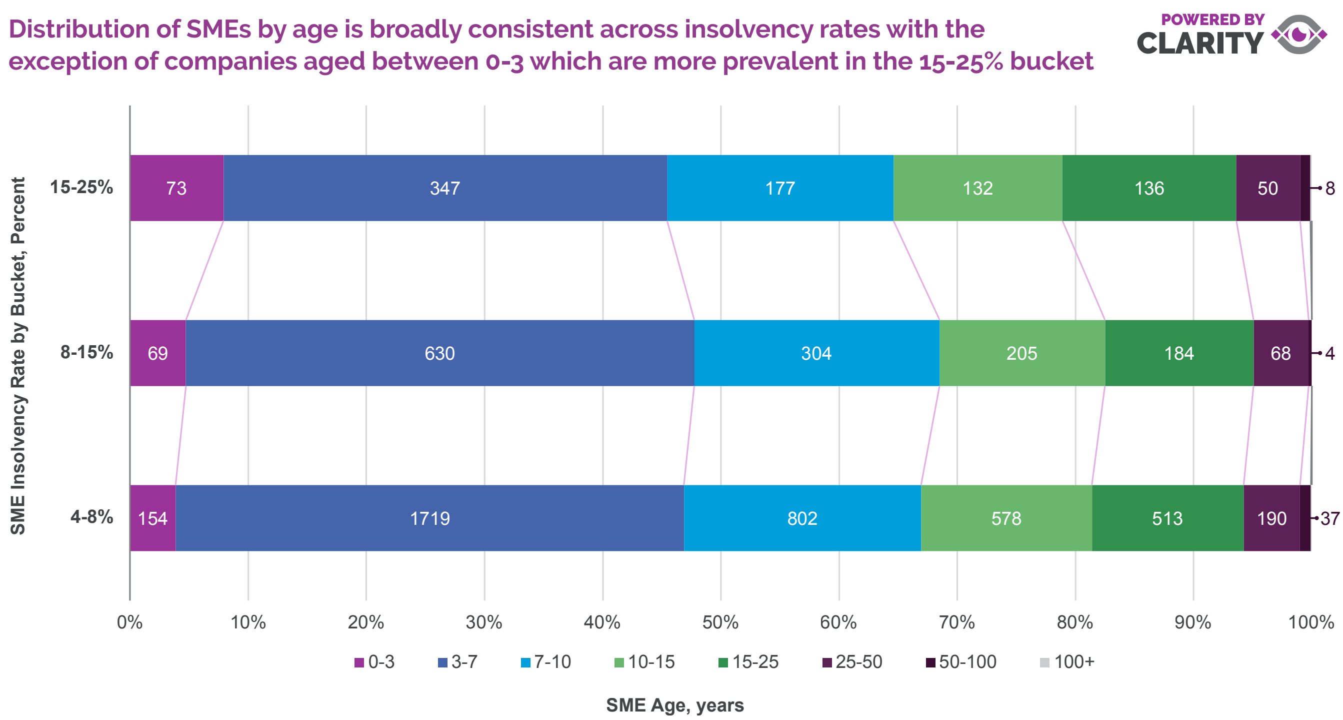
Start-ups and younger businesses at most risk

The number of SMEs aged between 0-3 years within the 15-25% insolvency rate bucket is high, validating the widely held view that early years to SMEs is vital to secure future viability.

It is often said that new business mortality is the highest within the first three years following incorporation and Clarity reveals granular evidence to support this claim. Thereafter, there is a broadly inverse relationship between age and mortality.

The distribution of SMEs by age is broadly consistent across insolvency rate buckets except for companies aged between 0-3 years which appear somewhat overrepresented in the 15-25% bucket.

Distribution of SMEs by age is broadly consistent across insolvency rates with the exception of companies aged between 0-3 which are more prevalent in the 15-25% bucket



Source: Quantuma Clarity

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www.quantuma.com/signup

The sectors at most risk of insolvency

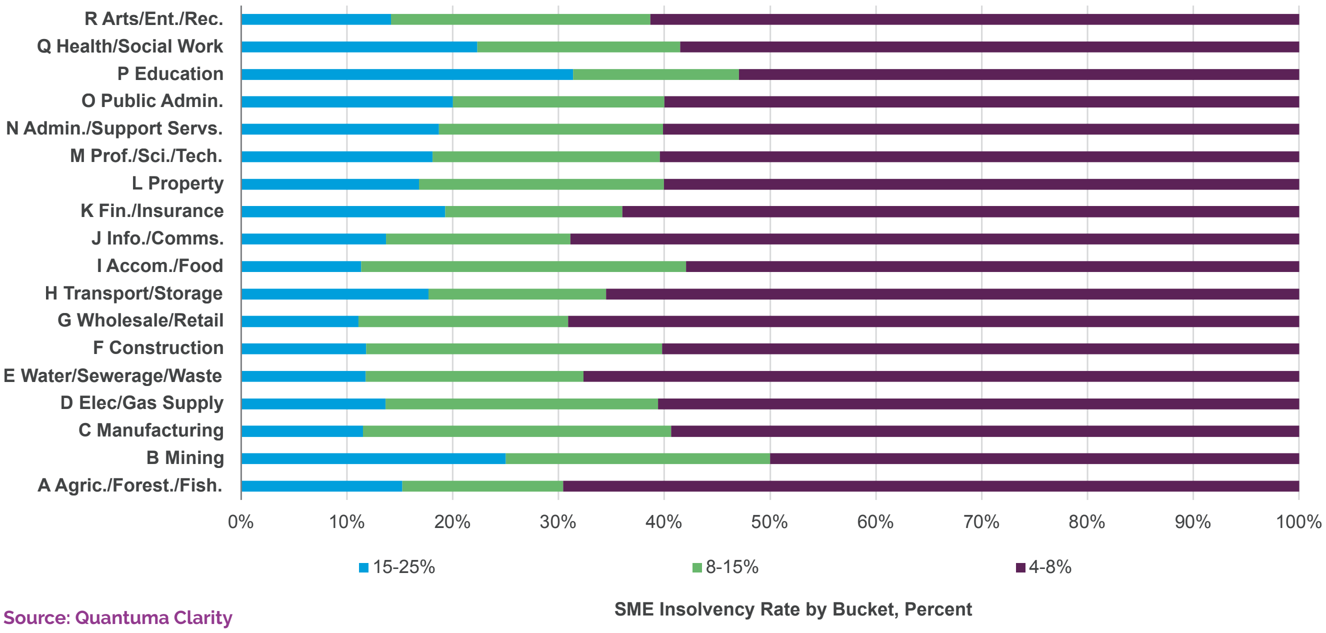
When looking at the most challenged segment of the SME market, it is apparent that the education and mining sectors have the highest share of SMEs with a 15-25% insolvency rate whereas the wholesale/retail sector has the lowest blended risk.

On the face of it, the results appear somewhat surprising. However, when looking into the details of the activities undertaken by SMEs in the education sector, namely, those in SIC division 85[11], it is perfectly understandable why such SMEs now face an elevated risk of failure.

Given that most SMEs active in the sector are public sector, the elevated risks relate to those SMEs whose activities have been severely curtailed by the lockdown restrictions. Similarly, for SMEs in the wholesale/retail sector, namely those in SIC divisions 45-47 inclusive[12], and consumption-led spending over the past two years, it is entirely defensible why such SMEs have the lowest blended insolvency risk of the most challenged segment.

However, it is still worth noting that for SMEs to fall within the scope of our insolvency propensity model, it must have an insolvency risk that is at least 4 times greater than the UK average of 1%.

Education and mining sectors are overweight in the most severe insolvency risk bucket whereas the wholesale/retail sector has the lowest blended insolvency risk



Source: Quantuma Clarity

[11]Includes pre-primary, primary and secondary education, higher education, sports and recreation education, driving school activities, educational support activities
[12]Includes wholesale and retail trade of vehicles, raw materials, food, beverage, tobacco, household goods, live animals, machinery, fuels, building materials, information and communications

More to come from Clarity

We hope you have enjoyed reading this first report on the uneven recovery and found the insight from Clarity and accompanying commentary useful.

Regional reports

Following this report, we will be publishing a series of regional reports covering the Eastern, Midlands (incorporating East & West), London, South West & Wales, South East, Scotland and the North (incorporating the North West, North East, Yorkshire and The Humber) regions. You can access these by visiting our website or by signing up to receive our regular updates and emails.

To sign up you simply need to **visit www.quantuma.com/signup** and complete the short form.

Connecting in person and virtually

Over the coming months we will also provide you with access to a series of webinars, in-person events and roundtables to provide you with a forum to explore the detail and what this means for you as advisers and your clients.

Sign up for our events by emailing **events@quantuma.com** or completing the form at **www.quantuma.com/signup**.

How to get in touch

If you would like to speak to our team about anything we have shared in this report, or about any aspect of our forthcoming programme, please get in touch with your local Quantuma office. Or you can visit our website to find out more.

Find out more about Clarity

Visit **www.quantuma.com/clarity** to find out more about our new and unique data model.

Read more insight on 'The uneven recovery'

Visit **www.quantuma.com/unevenrecovery** to access the latest reports, data and insight.

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Glossary of Terms/Definitions

Borrowing Ratio	Long Term Group Loans + Long Term Director Loans + Long Term Hire Purchase + Long Term Leasing + Other Long Term Loans + Short Term Loans + Current Liab. Group Loans + Current Liab. Director Loans + Current Liab. Hire Purchase + Current Liab. Leasing + Bank Overdraft / (Total Shareholders Funds – Intangible Fixed Assets)*100
Current Ratio	Total Current Assets/Total Current Liabilities. A measure of a company's liquidity and its ability to service short term debt obligations of no more than 12 months. A current ratio of less than 1.0 means that total current liabilities exceed total current assets creating potential negative working capital over time
DBT (Days Beyond Terms)	An expression of supplier invoice settlement delinquency expressed as a range of days past due
Debt Gearing Ratio	Long Term Group Loans + Long Term Director Loans + Long Term Hire Purchase + Long Term Leasing + Other Long Term Loans / (Total Shareholders Funds – Intangible Fixed Assets)*100
Equity Gearing Ratio	Total Shareholders Funds / (Capital Employed + Total Current Liabilities)*100
FSS (Financial Strength Score)	Calculated to predict the likelihood of company insolvency over the next 12 months 1-100 score where 100 is very strong and 1 is very weak. It is only available for registered companies, and is based almost exclusively on information contained in the filed accounts of a company
GS (Growth Score)	Likelihood of a business achieving high growth (60%+ growth in employment, adding at least 6 employees over a 3 year period) 1-100 score where 100 is likely to achieve high growth and 1 is unlikely to achieve high growth This model uses both financial and director information, information which is not available for non-registered companies
Pre-Tax Margin	(Pre Tax Profit / Loss / Total Turnover)*100
Return on Assets	Pre Tax Profit / (Total Assets–Total Current Liabilities)*100
Return on Capital	(52 * Pre-Tax Profit & Loss / Accounting Period) / (Capital Employed + Total Current Liabilities)*100
Return on Shareholder's Funds	(52 * Pre-Tax Profit & Loss / Accounting Period) / (Total Shareholders Funds)*100
Shareholder's Funds	Issued Capital + Share Premium Account + Revaluation Reserve + Retained Earnings + Other Reserves
Trade Creditors / Debtors	Trade Creditors / Total Debtors

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