Quantuma

The uneven recovery

In the Midlands Region

POWERED BY CLARITY

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The uneven recovery in the Midlands

Following the launch of our new programme 'The uneven recovery', we are pleased to share the second in our series of regional reports focusing on growth and distress in the Midlands. In this report we look at what our new data model, Clarity, is revealing about the prospects for growth and where we are likely to see distress for SMEs in the region.

The UK restructuring and advisory market

In 2021 and 2022 (to date) we have seen SMEs battle with the twin forces of Brexit and Covid-19. This has been exacerbated by recent surges in the cost of living (caused in part by the war in Ukraine), alongside pressures on supply chains and labour supply. This is all conspiring to create some of the most challenging trading conditions we have seen for decades for many, but not all, SMEs.

The Government's intervention measures had the desired short-term effect with subdued rates of corporate recovery during 2020 and 2021, allowing many businesses to 'tread water'. With the last of the intervention measures being lifted in March, in recent weeks, formal insolvency numbers have noticeably risen. We expect that in 2022 total insolvencies will reach 2019 levels (17,196) 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 war in Ukraine weigh heavily on the micro-end of the market and particularly owner-managed businesses in the region.

Whilst HMRC is still providing Time To Pay agreements to businesses, it appears the sheer scale of the debts that have been built up by businesses via additional borrowing and/or deferred payments are causing issues. Directors are realising how long it will take to pay them off resulting in either a decision to try and exit, restructure, or wind up the business.

Despite these challenges, our Corporate Finance team is seeing a buoyant deals market post-Covid restrictions, driven by many owners seeing the (relative) stability since mid-2021 as a time to consider their future exit plans. There has been continued appetite in private equity, which has provided a proactive source of capital whether for managed exits by owners, or for development and investment for growth and it will be interesting to see how long that remains the case. We also expect to see a market of opportunistic M&A as the pressure on businesses starts to bite, which is good news for those businesses with access to cash and management who are ambitious for growth. A successful acquisition in this situation needs careful advice and consideration but can still accelerate growth at more modest investment levels. So those that successfully execute such acquisition opportunities may advance the timeline for their business owners looking to dispose of their business in the coming years.

The number of solvent liquidations is also increasing, driven in part by contractors who have gone into employed roles and no longer need a limited company as a vehicle and are looking to take advantage of Business Asset Disposal Relief (BADR) as a tax efficient way of getting funds out.

Finally, we are also seeing an increase in transaction-related disputes, fueled by a buoyant deals market, and an increase in Covid-related business disputes. We expect that in 2022 commercial disputes will continue to increase due to where we are in the economic cycle and firms and individuals becoming more litigious as a result.

Richard Easterby
Director
Head of Birmingham
Restructuring & Insolvency

Marie Wadeson
Managing Director
Marketing & Business Development

Taz Rashid
Managing Director
Restructuring & Insolvency

Lee Brocklehurst
Director
Restructuring & Insolvency

Key takeaways

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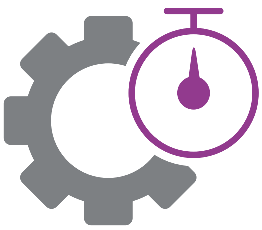
Midlands
outperforming London and the South East

Midlands SMEs have stronger growth and financial stability, on average, than those SMEs in London and the South East, further supporting the case for the 'Levelling Up' agenda and an increased level of Foreign Direct Investment (FDI) in to the region.

An ideal home for startups and younger businesses

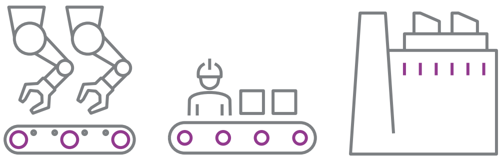
The Midlands region provides a better location for startups and businesses in the early years in comparison to the UK average. SMEs in the 0-3 year age bracket account for 8% of the most distressed SMEs in the UK compared to only 2% in the Midlands.

Midlands SMEs underperforming on profitability and efficiency



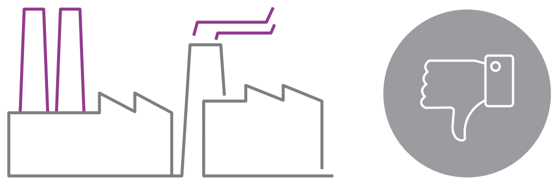
Clarity's financial ratio benchmarking component paints a stark picture of Midlands SMEs underperforming UK SMEs with respect to profitability and efficiency but outperforming them with respect to a higher Commercial Delphi which might suggest Midlands SMEs are more attractive borrowers than SMEs in the UK on average.

Midlands manufacturing continues to lead the way



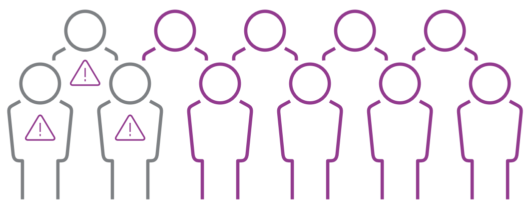
The Midlands manufacturing sector scores higher in terms of growth and financial stability against all other regions in the UK. Construction and Financial Services/Insurance sectors also look healthy in terms of their stability and growth prospects compared with Scotland, South East, the North, and London.

...but less attractive for maturing businesses



In the 3-7 year age bracket, Midlands SMEs account for 43% of the total number of the most severely distressed SMEs compared to 38% in the UK, raising a challenge for policymakers in the Midlands to look at the support available to those older businesses in the region.

Jobs at risk: a regional divide



There are 5,000 jobs at risk in the East Midlands compared to nearly twice as many – just over 9,000 – in the West Midlands. Of those jobs at risk in the West Midlands, 17% are also in SMEs that sit in the most distressed category (15-25%) compared with just 6% in East Midlands.

Informed by Clarity

Our new and unique data asset has been developed in partnership with Laeceum (a London-based advisory and consulting boutique serving corporates, financial sponsors, family offices, and entrepreneurs) 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 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.

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.

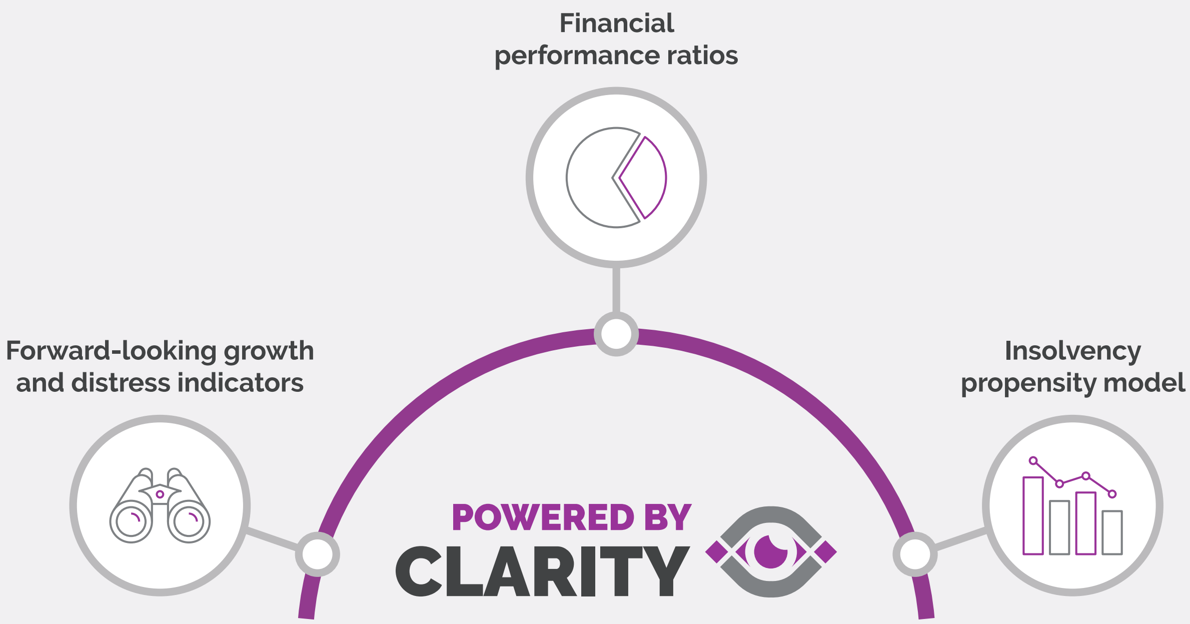
Developing your knowledge:

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

How Clarity works

Clarity takes data from multiple sources and then analyses and benchmarks that data to identify the sectors and individual companies 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.

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). 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.

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**.

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 categories are as follows:

- those SMEs that have an insolvency risk of between 4 and 8 times more likely;
- those with an insolvency risk of between 8 to 15 times more likely; and
- those with an insolvency risk of between 15 and 25 times more likely.

Find out more about Clarity:

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

Growth in the Midlands region

In our first report on 'the uneven recovery', published last month, we revealed Clarity's analysis of the UK's growth prospects and that there are a small number of regions where there is significant outperformance – the Midlands region came out on top alongside Scotland, the South West, and Wales.

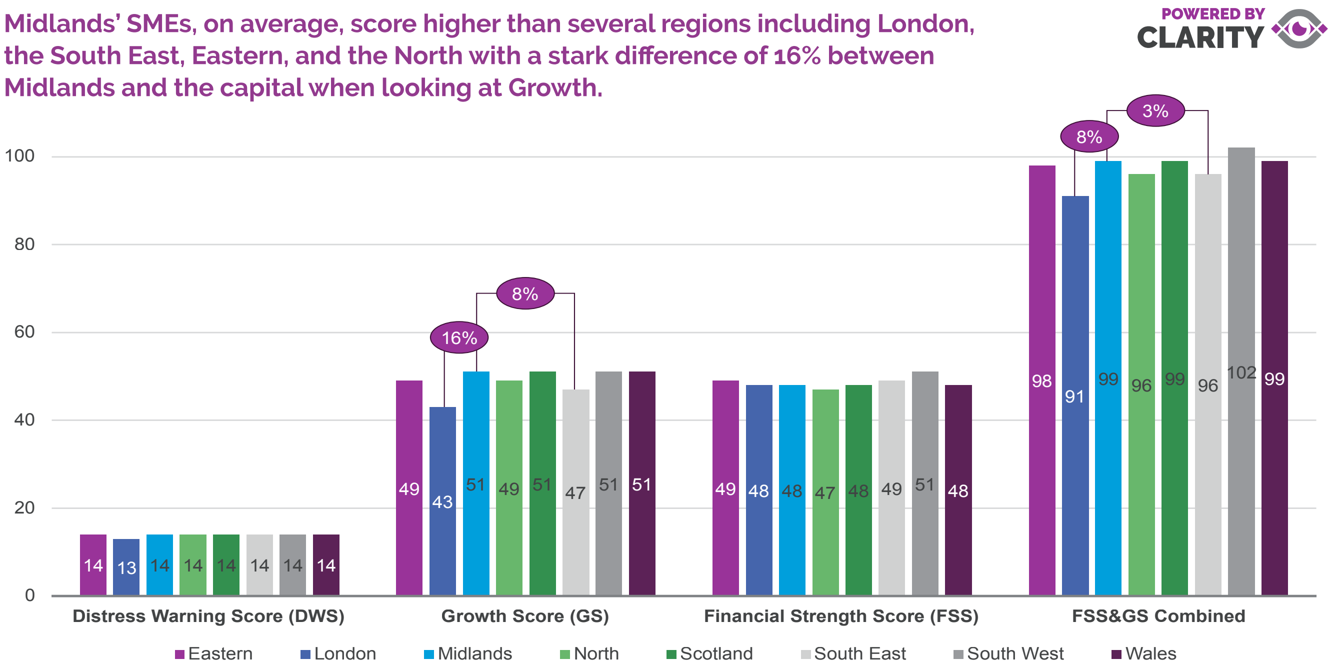
Looking at Clarity's Growth Score (GS) Midlands SMEs, on average, score higher than several regions including London, the South East, Eastern, and the North with a stark difference of 16% between Midlands and the capital. Furthermore, when we compare Clarity's Growth Score (GS) and Financial Stability Score (FSS) the Midlands is positioned in the top four regions in the UK.

Birmingham businesses driving growth

Despite the challenges presented by the last two years, Birmingham is set to rebound stronger this year than most cities in the UK with the second city's Gross Value Added (GVA) estimated to increase 7.5% year-on-year by the end of 2022. Hosting the forthcoming Commonwealth Games this summer of course fuels much of this optimism. According to recent reports the Games will bring an additional 4,526 jobs to Birmingham yearly until 2022, and 950 jobs will be available annually thereafter (*Source: Birmingham City University*). But the picture isn't uniform across the Midlands. When we look beyond Birmingham the picture is not so bright, with the West Midlands' Gross Value Added (GVA) forecast to be only 5.3% larger in 2025 compared with 2019; some way behind the UK's predicted total GVA increase of 8.3%. And in the East Midlands the picture is even less optimistic with Derby, Leicester, and Nottingham predicted to grow at a rate of 2.9%, 2.6%, and 2.3% respectively.

Backed by what we see in Clarity, we believe there is a challenge for the region and its advisory community to look at how we can support the growth prospects of Birmingham-based businesses whilst addressing what appears to be an imbalance across the Midlands with other parts of the region falling behind.

Midlands' SMEs, on average, score higher than several regions including London, the South East, Eastern, and the North with a stark difference of 16% between Midlands and the capital when looking at Growth.



Source: Quantuma Clarity

Supporting the case for yet more inward investment

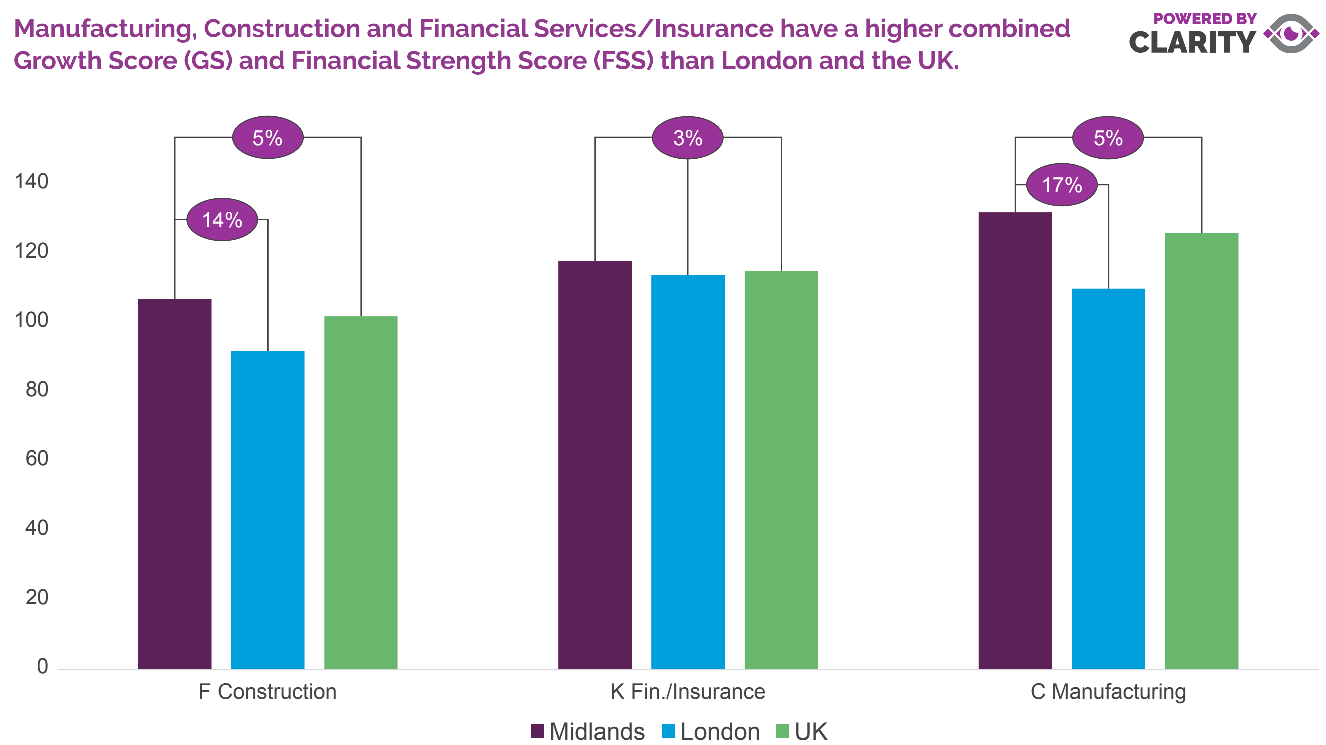
Historically, the South East and London have, naturally, been hotspots for inbound Foreign Direct Investment (FDI). As Clarity reveals the pandemic has most likely had an enduring impact with the Midlands now faring better on average than those businesses in London and the South East. We believe this strengthens the case for further inward investment in to the region to support continued development of infrastructure to support Midlands SMEs. The good news is some progress is already being made. In a recent report by *Irwin Mitchell and the UK Powerhouse*, the West Midlands ranked third for the number of FDI projects in 2019/20 (with London and the South East 1st and 2nd).

A sector view: Midlands manufacturers lead the way

In our national report on the uneven recovery we revealed that UK manufacturing was leading the way when we compare the growth prospects of sectors with a Growth Score of 75 vs the median of 50.5. This is also reflected in Clarity's view of Midlands manufacturers when we compare growth prospects against all other regions with Midlands SMEs in this sector scoring higher than all other regions. This is in part being driven by the continued onshoring of manufacturing facilities and from exports – which rose in the West Midlands by 65% in Q2 2021 compared with the national average of 32% (*Source Manufacturing Technology Centre*). The West Midlands is also seeing a boom in low-carbon manufacturing and goods which grew by more than 7% in 2020 despite the issues presented by the pandemic and with Coventry and Warwickshire employing 28 times more than the UK average in electricity transmission and businesses in the Black Country employ as many as five times the average in securing recycled materials (*Source: Invest in the Midlands*).

Other sectors such as Construction and Financial Services/Insurance also provide reasons to be optimistic about the future of the region when we compare their growth prospects with that of London and the UK as shown in the graph below. In the Construction sector Birmingham is - again – the most likely driver behind these statistics. In 2021 the number of schemes almost doubled in comparison to 2020 with the completion of 14 residential schemes, two office developments, and one development scheme in the Hotel and Student Accommodation sectors (*Source: Deloitte Crane Survey 2022*). In the Financial/Insurance sector, Birmingham is thriving and now boasts 53,000 companies employing 343,000 people and is set to grow by a further 31% by 2030 (*Source: Invest in the Midlands*).

Manufacturing, Construction and Financial Services/Insurance have a higher combined Growth Score (GS) and Financial Strength Score (FSS) than London and the UK.



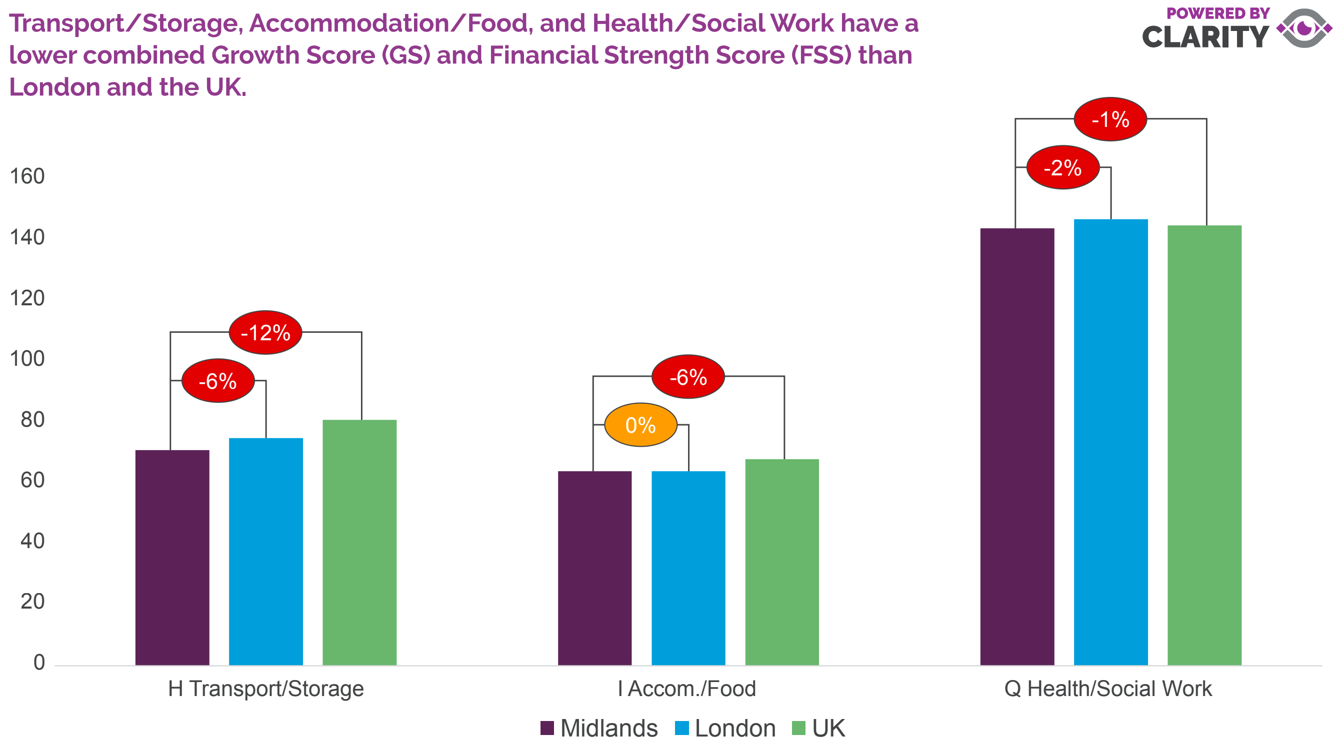
Source: Quantuma Clarity

Sectors to keep a watchful eye on

Clarity reveals that whilst there are several sectors in the Midlands performing well in comparison to other regions, there are areas where there is cause for concern and advisers should keep a watchful eye on those where their combined Growth Score (GS) and Financial Strength Score (FSS) is lower than that of SMEs across other parts of the country. Accommodation/ Food, Utilities, Healthcare, and Transport/ Logistics SMEs rank much lower on financial stability and growth in comparison to all other UK regions.

Sectors such as Accommodation/Food may come as little surprise as the region is not necessarily tourism-led, especially when we compare against the likes of London and South West. However, such low scores in Transport/Storage and Health/Social Work, relative to other regions, is perhaps alarming. At this stage it is difficult to say what is driving this, but we will be tracking the development of those sectors as we refresh Clarity's data in September and analyse their movements.

Transport/Storage, Accommodation/Food, and Health/Social Work have a lower combined Growth Score (GS) and Financial Strength Score (FSS) than London and the UK.



Source: Quantuma Clarity

How efficient are Midlands SMEs?

In addition to growth and distress, Clarity measures the efficiency of SMEs looking at leverage, profitability, liquidity, and risk. Here we reveal a stark picture of Midlands SMEs underperforming UK SMEs with respect to profitability and efficiency but outperforming them with respect to lending suitability.

Our analysis reveals a somewhat contradictory position assumed by Midlands SMEs with what has been revealed by the financial ratio analysis. A higher Commercial Delphi (higher is better than lower) might suggest that Midlands SMEs are more attractive borrowers than SMEs in the UK as a whole. However, at the same time, we can observe that, in comparison to their UK peers, Midlands SMEs have:

- have a higher Debt Gearing;
- deliver a much lower Return on Shareholders' Funds; and
- have a lower Return on Assets.

We believe that the lower profitability levels point towards a defining feature of Midlands SMEs and one that we feel needs to be addressed to help bring them to parity with the UK as a whole. Analysis of a representative sample of relevant balance sheets of Midlands SMEs points to surplus shareholders' funds compared to UK SMEs. One reason for this could be that funds are not being effectively used within the business either to fund expansion and/or capital investment, nor are those funds being used to service shareholders in the form of dividend payments.

Whilst this does provide some support for a higher Commercial Delphi, we do not feel that such actions are ultimately in the best interests of such SMEs and consequently feel that advisers should be tailoring their services and offerings for Midlands SMEs towards helping present options around more effectively deploying capital within the business for reinvestment to support growth, expansion, and boost profitability.

Midlands SMEs have lower profitability and higher risk compared to UK SMEs.

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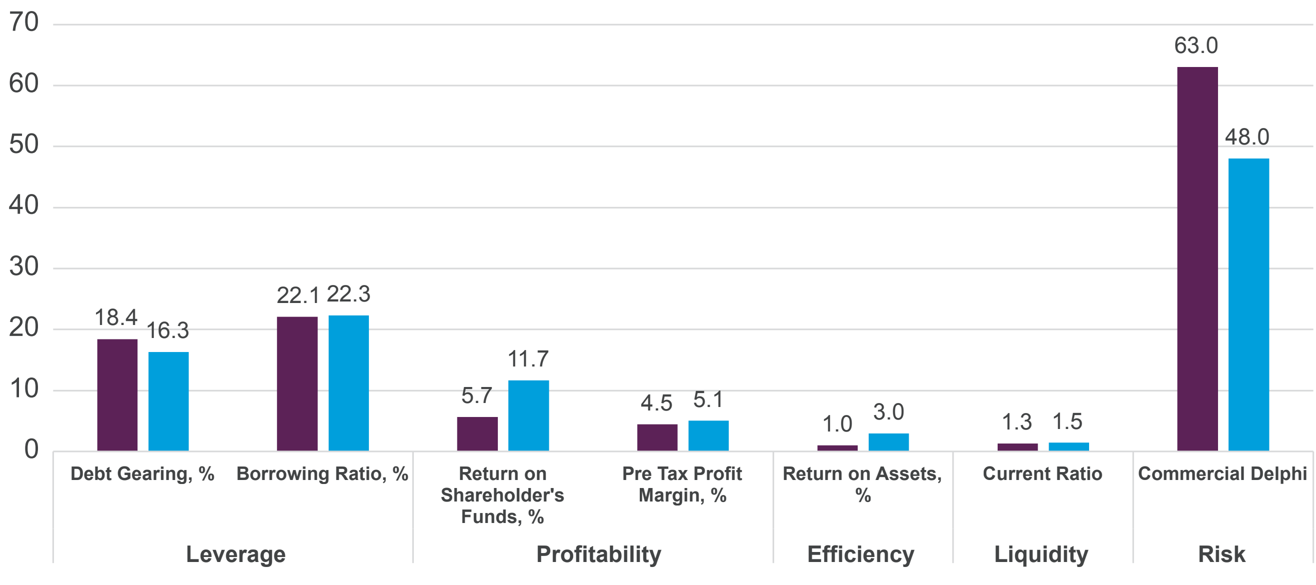


Source: Quantuma Clarity

> “There is a challenge for the region and its advisory community to look at how we can support the growth prospects of Birmingham-based businesses whilst addressing an imbalance across the Midlands with other parts of the region falling behind.”

Distress in the region

Earlier in this report, we revealed that distress across the UK regions is broadly consistent. Indeed, this is the case for the Midlands region as Clarity reveals that the region is, on average, in line with the UK. There are, however, some areas of concern when we dive a bit deeper in to the data.

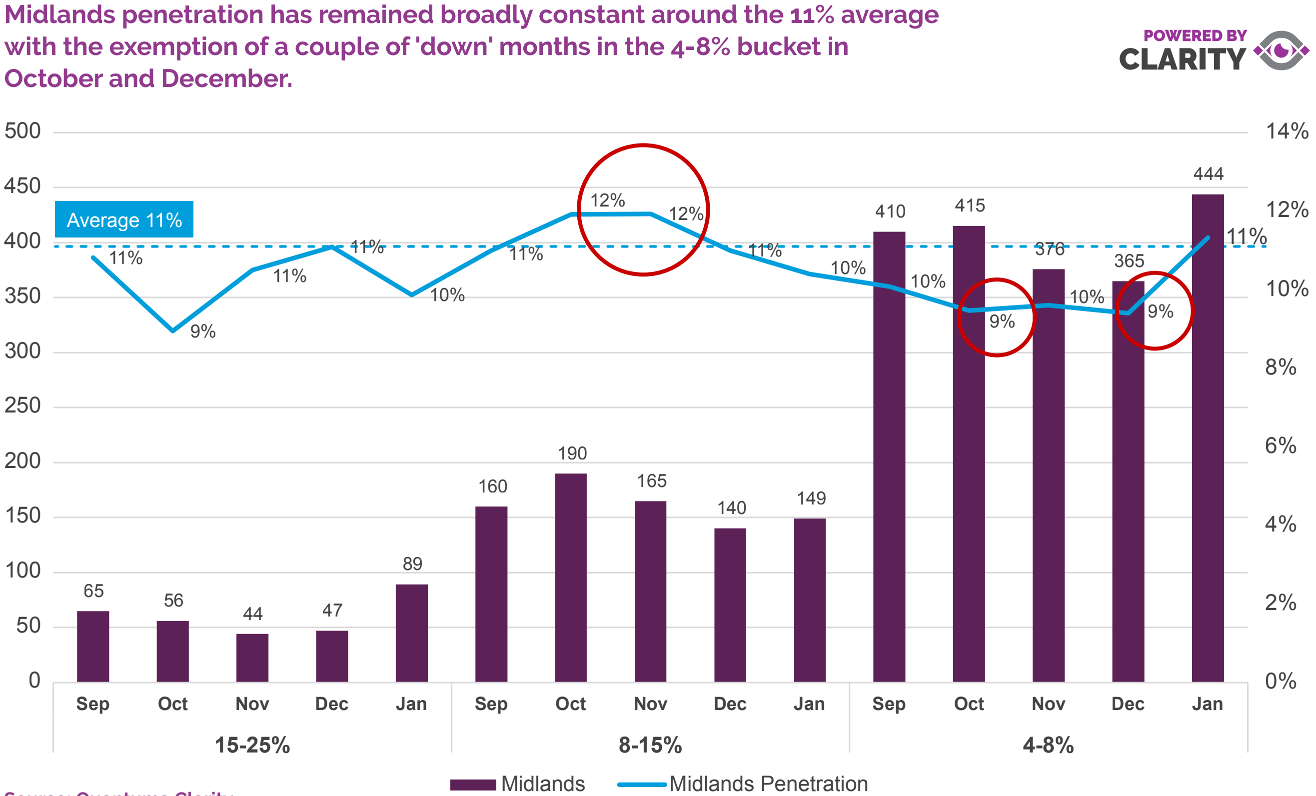
Insolvency propensity model

In this section of the report, we use data taken from our insolvency propensity model which allows us to early identify three 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, including:

- those SMEs that have an insolvency risk of between 4 and 8 times more likely;
- those with an insolvency risk of between 8 to 15 times more likely; and
- those with an insolvency risk of between 15 and 25 times more likely.

The number of Midlands SMEs that are captured in Clarity's categories of distress (see above) averaged 11% in the 5-month period between September 2021 and January 2022. Whilst there have been a couple of 'up' and 'down' months over the period, the peaks and troughs are relatively minor and, in our view, not due to unique characteristics of the Midlands market compared to the UK. We do not expect to see that this variance will change significantly over the next few months between now and the publication of the Midlands update report later in the year (due September).

Midlands penetration has remained broadly constant around the 11% average with the exemption of a couple of 'down' months in the 4-8% bucket in October and December.



Source: Quantuma Clarity

Support for startups and younger businesses

Clarity analyses the distress of SMEs by age distribution and in the Midlands region we see that the number of the most severely distressed SMEs in the 0-3 year age bracket is significantly lower than in the same category for the UK as a whole. Such SMEs account for only 2% in the Midlands, compared with 8% in the UK. This difference is then offset in the 3-7 year age bracket where such SMEs in the Midlands account for 43% of the total compared to 38% in the UK as a whole.

This points to the Midlands providing a better location for startups and businesses in the early years in comparison to the UK average. Indeed, in 2021 Birmingham was crowned the UK's regional startup capital for a seventh year running, with 18,394 new enterprises starting life in the city throughout 2020. This marks the highest volume of startups outside London, and a 26.8% uplift from the numbers recorded in 2019 – *Source Centre for Entrepreneurs (CfE)*.

We believe that this finding points to a unique characteristic of the Midlands SMEs' market. That is, that Midlands SMEs are typically less fragile in their embryonic stage than other SMEs but that they become more vulnerable as they enter their infancy. Consequently, we believe that whilst many advisers and the lending community may typically be focused on supporting an SME through its startup phase, in the case of Midlands SMEs, we believe that the data suggests that more support is needed on the post-startup phase once the SME has been trading for more than three years.

Looking at age distribution of Midlands SMEs by severity of distress shows a much lower number in the 0-3 years age bracket vs UK, but a higher number in 3-7.

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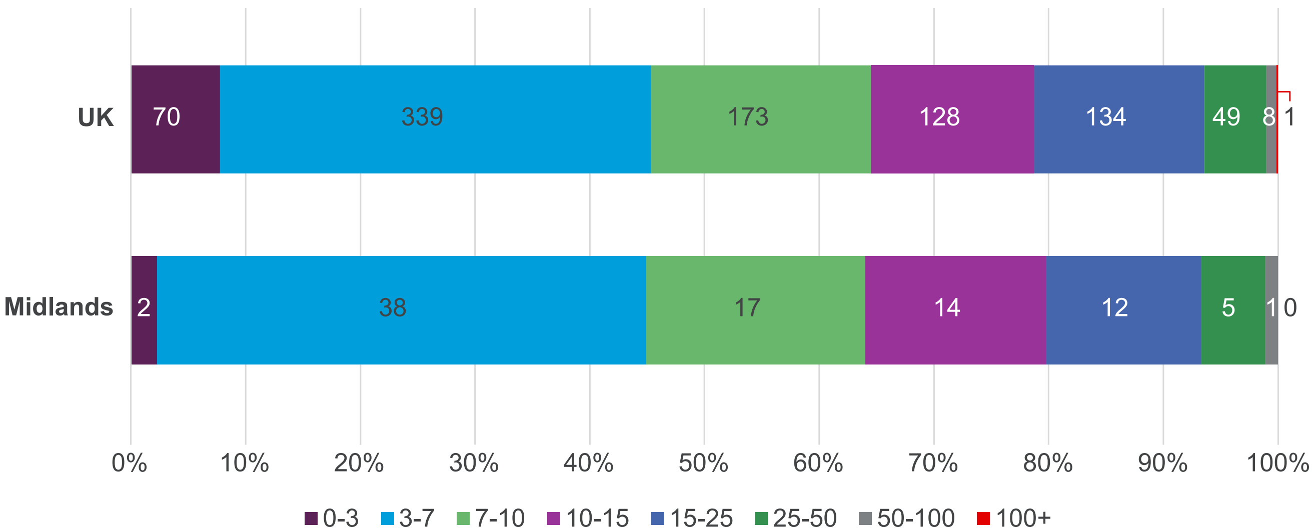

Source: Quantuma Clarity

Jobs at risk in the East and West Midlands: a regional divide

Historically there has been a divide in the region between East and West Midlands, with the West Midlands being generally considered as one of the powerhouses of the UK economy. And as mentioned earlier in the report, the outlook (in GVA terms) is projected to be much lower in the East Midlands in 2022.

Taking Clarity's insolvency propensity model, we have analysed those SMEs in all categories of distress and the number of jobs that are potentially at risk. The results are alarming and perhaps counter-intuitive with just over 5,000 jobs in SMEs that are distressed in the East Midlands compared to nearly twice as many – just over 9,000 – in the West Midlands. Of those jobs at risk in the West Midlands, 17% are also in SMEs that sit in the most distressed category (15-25%) compared with just 6% in the East Midlands.

Jobs at risk: East Midlands has a much lower number of overall jobs at risk and less of those jobs are in SMEs in the most distressed category in comparison to West Midlands.

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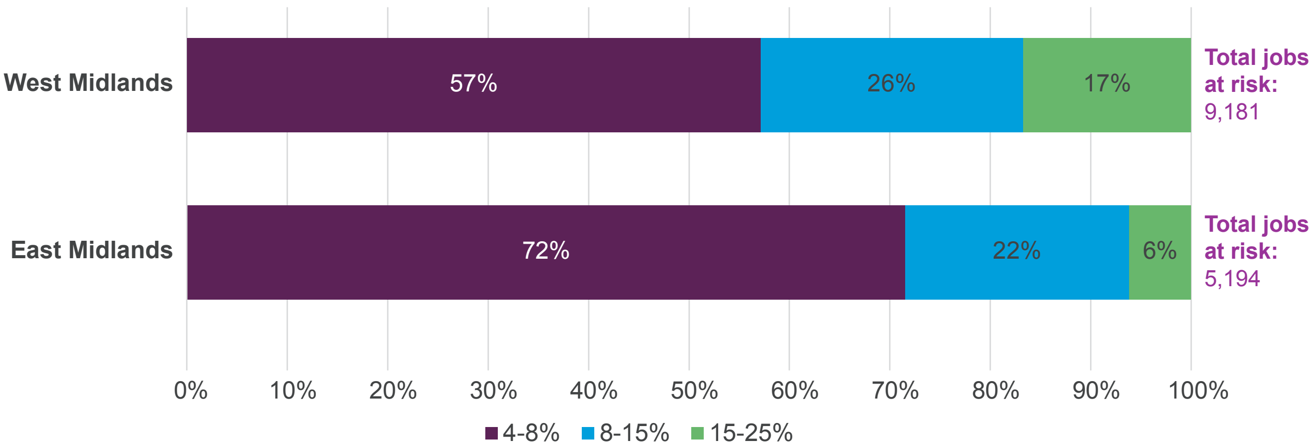

Source: Quantuma Clarity

What comes next?

The uneven recovery programme includes an ongoing series of reports focusing on trends in growth and distress in the UK economy.

In September we will produce a new series of regional reports revealing the latest data from Clarity and comparing the next set of results with this report.

To get a copy of this report simply register on our website here: **visit 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.

Key contacts

Richard Easterby
Director
Head of Birmingham
Restructuring & Insolvency
+44 (0)774 131 3163
richard.easterby@quantuma.com

Marie Wadeson
Managing Director
Marketing & Business
Development
+44 (0)746 454 5678
marie.wadeson@quantuma.com

Taz Rashid
Managing Director
Restructuring & Insolvency
+44 (0)796 878 2161
taz.rashid@quantuma.com

Lee Brocklehurst
Director
Restructuring & Insolvency
+44 (0)746 927 9928
lee.brocklehurst@quantuma.com

Acknowledgements

LAECEUM
STRATEGY | ADVISORY | DATA | 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 Adviser John Mould, Analyst Oliver Benson, and Economist Anjalika Bardalai. You can find out more about Laeceum here: **www.laeceum.com**

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
Commercial Delphi	A single score to assess commercial viability derived using a combination of company accounts, payment performance, director information to predict defaults and suitability for lending
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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