Quantuma

The uneven recovery

In the North

POWERED BY CLARITY

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The uneven recovery in the North

Following the launch of our new programme 'The uneven recovery', we are pleased to share the third in our series of regional reports focusing on growth and distress in the North. 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 are seeing an almost perfect storm for SMEs as they 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 of course 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 failure during 2020 and 2021, allowing many businesses to 'tread water'. In recent months, with the last of the intervention measures being lifted in March, 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 are 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 and this is resulting in either a decision to try and exit, restructure, or wind up the business.

Despite these challenges our Corporate Finance team are 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. As fundamentally good businesses with viable products and business models start to struggle with the aforementioned macro headwinds - through no fault of their own - we do expect to see a growing trend of opportunistic M&A as those cash rich companies with strong balance sheets and growth hungry management teams will look to pick up good businesses more cheaply than they otherwise would. Potential buyers in this situation will necessarily have to carefully consider a range of pros and cons beyond the typical considerations in a "normal" market transaction. Getting the right deal adviser with relevant situational experience is paramount.

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. The increase in solvent liquidations is also being fuelled by situations where owner managers are unable to obtain their desired exit multiples or alternatively, agree a clean break from their business where a sale is conditioned on them remaining with the business in a transitional capacity post deal for a number of years. In these scenarios we are seeing owner managers prefer a solvent liquidation process especially where there are sufficient net assets to provide a substantial tax efficient return and allow for a complete exit from the business.

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.

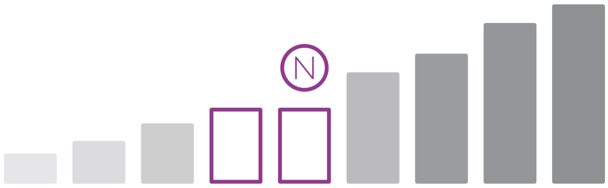
Robert Parry
Managing Director
Head of North West
Forensic Accounting & Investigations

Rehan Ahmed
Managing Director
Head of Yorkshire & North East
Restructuring & Insolvency

Marie Wadeson
Managing Director
Marketing & Business Development

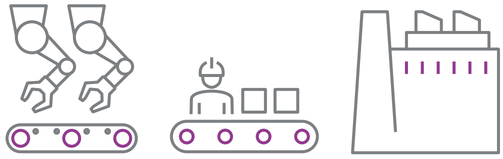
Key takeaways

Growth prospects for the region: a middle of the pack performance



When it comes to growth SMES in the North sit in the middle of the pack when we compare its performance against all other regions in the UK, behind four of the eight, marginally ahead of London, the South East and on par with the Eastern region.

Manufacturers help lead the region's recovery



The manufacturing sector remains a key sector for growth in the North and on average SMEs in this sector have stronger growth prospects than almost every other region in the UK.

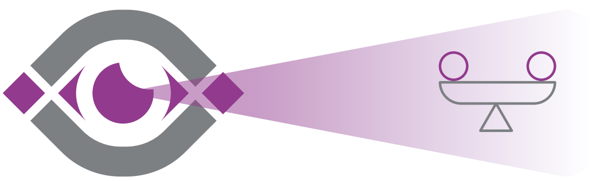
Sectors in the North with stronger growth prospects vs the UK average

SMEs in construction, wholesale and retail, manufacturing, education, and agriculture sectors in the North are showing outperformance when compared to the UK average.

Sectors to keep a watchful eye on

Sectors in the region where growth prospects and financial stability is low, compared to the UK average (combining GS and FSS), include financial services, administration and support services, transport and logistics, accommodation and food, and the arts.

Levels of distress in the region



Overall levels of distress in the region have remained broadly stable in comparison to the UK. What's more from November 2021 to January 2022 the number of SMEs in the most severely distressed category started to decrease in the region whilst they increased in the UK as a whole.

Distress and jobs at risk: Manchester vs Leeds

Over 80% of employees in distressed SMEs based in Leeds are in the lowest category of distress (4-8% category). Whereas 95% of all employees in distressed SMEs based in Manchester are in the higher 8-15% category, pointing to a much higher proportion of jobs at risk in Manchester on a relative basis.

Informed by Clarity

Our new and unique data asset has been developed in partnership with Laeceum (an 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.

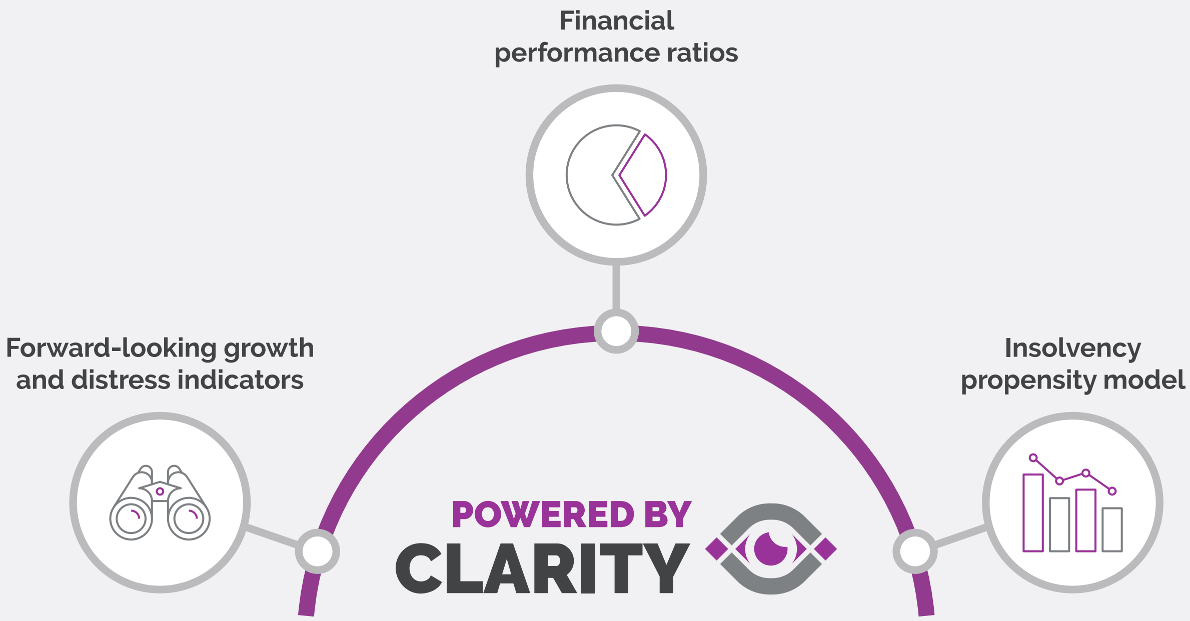
Developing your knowledge:

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 help 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).

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 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 and financial stability in the region

In our first report on 'the uneven recovery', published last month, we revealed Clarity's analysis of the UK's growth prospects by region. By comparison with other regions, SMEs in the North were ranked in the middle of the pack but were amongst the lowest regions in terms of financial strength.

When it comes to growth, SMEs in the North sit in the middle of the pack when we compare performance to other regions in the UK, behind Midlands, South West, Wales, and Scotland, marginally ahead of London and the South East, whilst on par with SMEs in the Eastern region. Perhaps more concerning is the position of SMEs in the North when it comes to financial stability where they rank lowest of all regions across the UK.

The North West and North East post-pandemic divide

Covid-19 has, of course, impacted almost every business in the UK and in many respects, we are yet to see the true cost of the pandemic. And as we have seen, the recovery is uneven; for some sectors and regions the impact has been far greater, and their recovery will take much longer.

Businesses in the North West were amongst those that were most impacted by the pandemic and by the end of 2021 the region's economy - measured by Gross Value Added (GVA) - had recovered to 96.1% of its size in 2019, making it the second slowest region to recover - the West Midlands region being the slowest. However, as the country started to move out of lockdown restrictions, the region recovered well. The latest data from the Government's Census 2021 report (July to September 2021) shows that the North West experienced growth in Quarter 3 2021 and according to the latest data from NatWest's PMI survey, economic activity in the region rose to a nine-month high of 58.7 in April. Some of the drivers behind these numbers will include the performance of cities like Liverpool and Manchester and how they have fared in their post-pandemic recovery.

UK regional growth comparisons: SMEs in the North, on average, score lower than Midlands, South West, Wales, and Scotland, are marginally ahead of London and the South East, whilst on par with SMEs in the Eastern region.

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Source: Quantuma Clarity

At the start of the year Avison Young published a report stating that Liverpool could see record levels of employment this year with the creation of 6,000 new jobs. Manchester was also one of the strongest performing cities in the UK in Q4, 2021, in terms of GVA at 6.4% and employment growth at 2.1% (Source: Irwin Mitchell's UK Powerhouse report).

In May there was further positivity in the region as Lloyds Bank published its latest 'Business Barometer' and revealed that business confidence amongst SMEs in the North West rose placing it in the top three regions, with London in first place and West Midlands second.

In contrast, the picture for the North East is not so positive. In May the Office for National Statistics (ONS) released their data for quarterly GDP growth in each of the UK regions for July to September 2021. In the report it states the North East experienced the largest quarterly drop (-1.2%). The ICAEW also recently reported in their 'Coronavirus Economic Outlook' report that growth in the North East is expected to be the weakest of any region over the 2020-25 period and will have a slower recovery in comparison to other UK regions. According to the report the North East is still struggling 'to move away from a high dependency on the public sector' and this is likely to mean a slower recovery for the region and particularly Yorkshire.

Covid-19 has had a significant impact on businesses in the region and as new pressures build from the cost-of-living crisis and a recession is all but certain, they face new challenges no sooner after the lockdown restrictions start to feel like they are well and truly behind us. Whether this disparity continues to grow across the North West and North East remains to be seen. We will explore the region's growth prospects and take a closer look at Clarity's analysis in more detail in our updated report in September.

Sectors in the region that are performing well

Compared to the UK average, there are several sectors in the North where Clarity reveals outperformance in terms of growth. Those sectors include Construction, Education, Manufacturing, and Agriculture, with single digit growth and Wholesale and Retail which is 10% higher than the UK average.

Sectors in the North and growth prospects: Across the top 20 sectors Clarity analyses, SMEs in the North have stronger growth prospects across Construction, Education, Manufacturing, Agriculture, and Retail and Wholesale.

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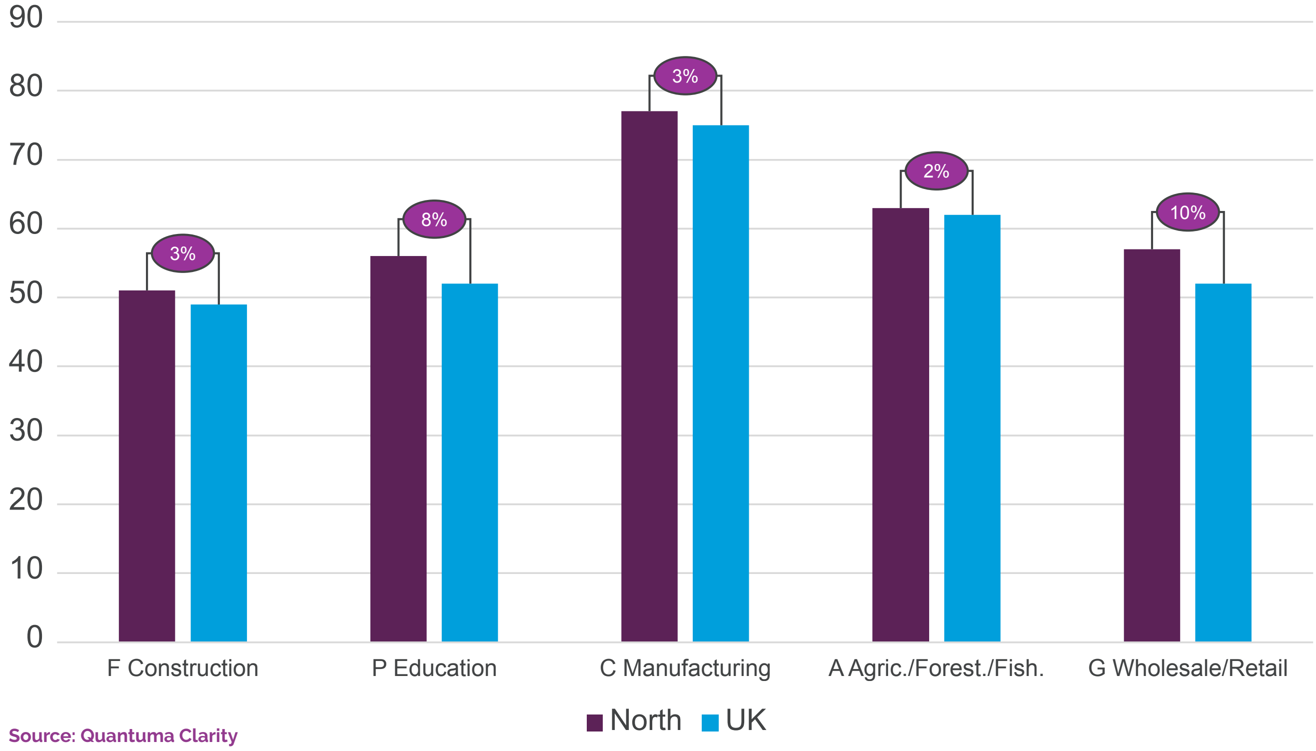

Source: Quantuma Clarity

Some of these sectors may come as no surprise, such as Manufacturing, and Agriculture given the concentration of SMEs in the region and their strength driven by locational advantages. However, Education, Construction and Wholesale and Retail are perhaps unexpected.

Towards the end of 2020 the Construction sector in the North West showed promising signs of returning to pre-pandemic performance. According to Glenigan (construction industry insight and intelligence business), the North West had the highest value of underlying project-starts in the UK (less than £100m in value) and was up 58% vs the same time in 2020 and 13% on 2019. In the Construction Skills Network outlook report they predict that Yorkshire and Humber will achieve an increase of 3.9% in construction work – ahead of the UK at 3.2% - with the fastest growing areas being infrastructure, private housing, and repairs and maintenance.

Manufacturers in the region making progress in the recovery

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 manufacturers in the North when we compare growth prospects for those SMEs in the sector against all other regions.

Manufacturing is a key sector for growth in the region especially when we consider the North West is the UK's largest employer of manufacturing jobs. In 2021 SMEs in the sector in the North West had a significant rebound with an output balance of +63, the strongest of any region in the UK (Source: Make UK). In Yorkshire, data on manufacturing output performance also pointed towards signs of a strong recovery with SMEs across the region generated more than 71% more in sales in the first three quarters of 2021 vs the same period in 2020 – making it the top performing region in the UK, followed by SMEs in the North East, recording a performance of 64% more in sales.

Manufacturing sector growth prospects: Manufacturers in the North have stronger growth prospects against all other regions in the UK except for those in the Midlands.

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Source: Quantuma Clarity

Sectors to keep a watchful eye on

Clarity reveals that whilst there are several sectors in the North 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 the UK average.

According to data from Clarity, Financial Services, Administration/ Support Services, Transport/Storage, Accommodation/Food and Arts/Entertainment/Recreation all have scores that are lower than the average of SMEs across the country. 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.

Sectors in the region falling behind: Financial Services, Administration/Support Services, Transport/Storage, Accommodation/Food, Arts/Entertainment/Recreation sectors in the region have a lower combined Growth (GS) and Financial Strength Score (FSS) when compared to the UK average.

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Source: Quantuma Clarity

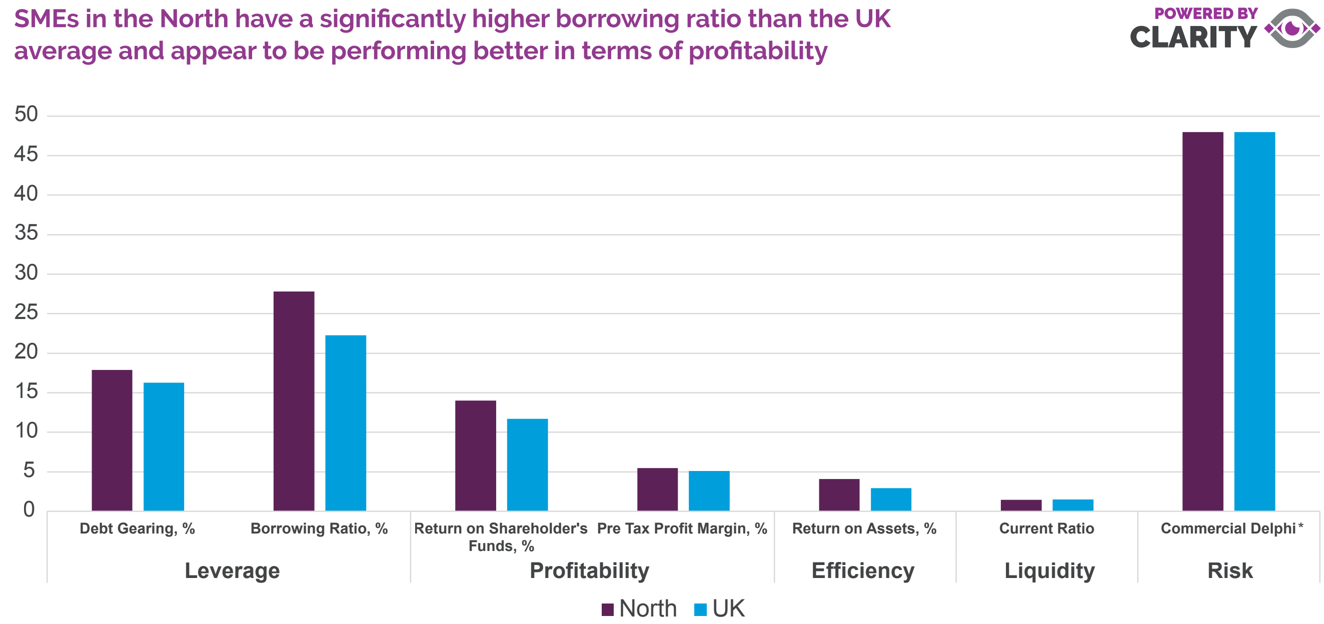
How efficient are SMEs in the North?

In addition to growth and distress, Clarity measures the efficiency of SMEs looking at leverage, profitability, liquidity, and risk.

Our analysis of SMEs in the North reveals that whilst they have a significantly higher borrowing ratio than the UK average (27% in the North vs 22% in the UK), they appear to be performing better in terms of profitability – measured both by return on shareholders' funds and pre-tax profit margin.

Similarly, SMEs in the North also appear to be operating more efficiently than their counterparts across the UK as measured by Return on Assets. When looking at the Commercial Delphi scores of SMEs in the North compared to the UK, they are identical meaning that, overall, SMEs in the North are as viable as their counterparts across the UK manifesting the same level of default risk for borrowing obligations.

SMEs in the North have a significantly higher borrowing ratio than the UK average and appear to be performing better in terms of profitability



Source: Quantuma Clarity

*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.

Distress in the region

In our first uneven recovery report for the UK, we revealed that distress across the UK regions is broadly consistent. In comparison with other regions in the UK, SMEs in the North have the same average Distress Warning Score (DWS) but have a lower Financial Strength Score (FSS) indicating they may be marginally more prone to risk of distress.

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.

Evolution of distress in the region

When comparing the evolution of distress in the five-month period between September 2021 and January 2022, we can see that the number of distressed SMEs in the North across all three categories (see above) remained broadly comparable in the 4-8% category, with the North East and North West and relative share between the two sub-regions also remaining broadly constant. However, within the 8-15% category, whilst there was a material spike in the number of distressed companies in the UK in the month of December, no such pattern emerged for SMEs in the North East or North West regions.

Perhaps the most striking feature of the graph below is the almost counter-cyclical development in the region in the 18-25% category from November 2021 to January 2022. At a time when the number of distressed companies in the UK was on the up, the relative share of such companies in the North East and North West started to decrease.

Evolution of distress in the region: Levels of distress in the region have remained stable vs UK and from November 2021 to January 22 the number of SMEs in the most severely distressed category started to decrease in the region whilst they increased in the UK as a whole.

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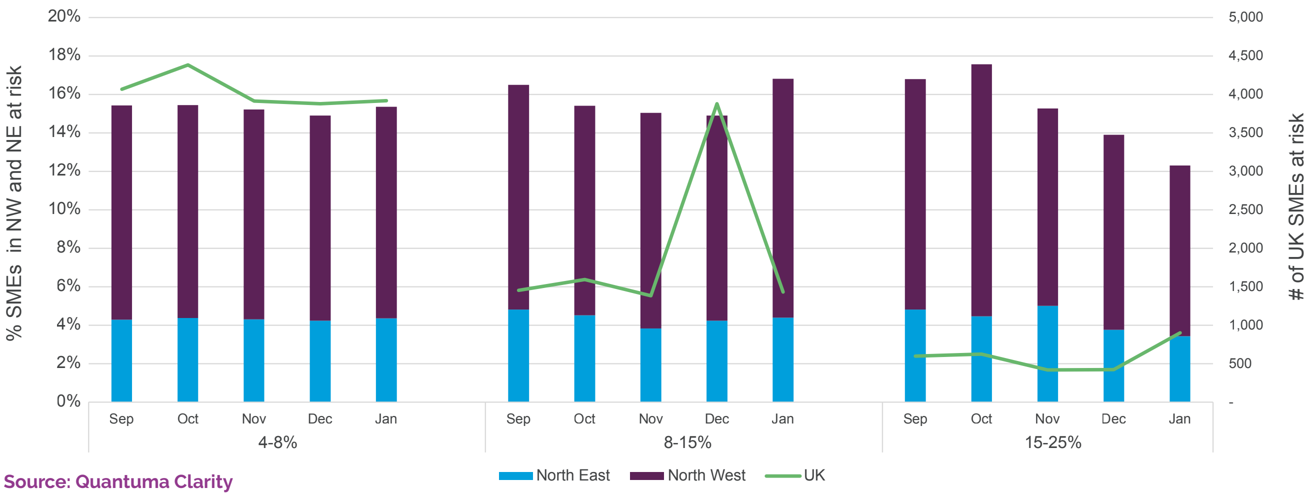


Source: Quantuma Clarity

The sectors driving the region's recovery

The pandemic was nothing short of catastrophic for the hospitality, leisure, and tourism sector, with most businesses being propped up by furlough and the Government's fiscal support schemes. As we now return to some normality, it is promising to see that across many cities in the North there are signs of a strong recovery which we have covered earlier in this report.

Back in March a study by Northern Restaurant & Bar (NRB) revealed that Liverpool was leading the sector across the UK with a 4.4% increase in new restaurant, bars and pub openings between September 2021 and December 2021, with Manchester registering a 2.5% growth in new openings, ahead of London which had growth of 1.6%. We strongly suspect this resurgence in one of the largest sectors for both the North West and North East is one of the key factors behind the reduction in businesses in the most severely distressed category.

Comparing sector distress in the North West and North East

Clarity enables us to look at those sectors that are experiencing higher levels of distress than the UK average, helping to inform where early intervention should be focused. We have analysed those sectors by categories of distress across both the North West and North East to identify any differences or patterns between the two sub-regions.

- Looking at Clarity's data set we see that levels of distress are broadly the same within the least distressed category of 4-8%.
- However, this changes as we move to the more distressed segments of 8-15% category where we see variations on a relative basis within Information/Communications, Financial Services/Insurance, Property, and Professional/Science/Technology.
- And for the most severely challenged SMEs, there is a significant difference between the North East and North West within Accommodation/Food, Administration/Support Services.

	8-15%	
	North East	North West
Property	**20%**	12%
Fin./Insurance	**13%**	6%
Info./Comms.	**10%**	6%
Prof./Sci./Tech.	3%	**11%**

	15-25%	
	North East	North West
Accom./Food	**11%**	7%
K Fin./Insurance	2%	**4%**
Prof./Sci./Tech.	5%	**8%**
Admin./Support Servs.	8%	**12%**

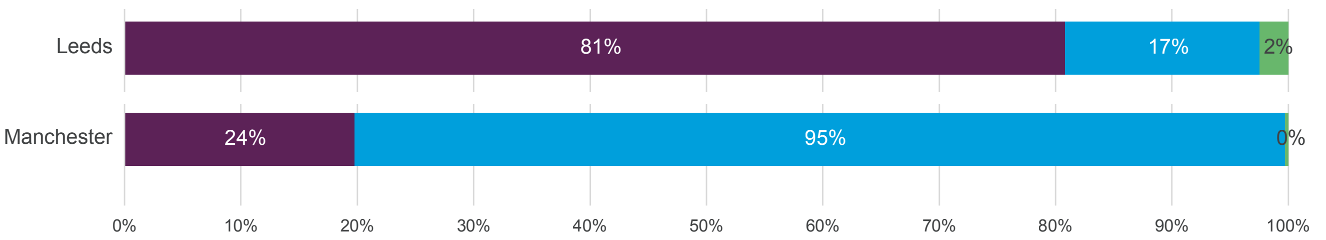
> *"SMEs in the North have the same average Distress Warning Score (DWS) but have a lower Financial Strength Score (FSS) indicating they are marginally more prone to risk of distress."*

Jobs at risk in the region

Clarity allows us to identify those SMEs that are most at risk of failure and analyse the jobs that are exposed as a result. For this report we have taken a closer look at two of the largest commercial hubs in the region: Manchester and Leeds, looking at the distribution of employees by insolvency distress category. Our findings are interesting and reveal a significant disparity between the two cities in absolute and relative terms.

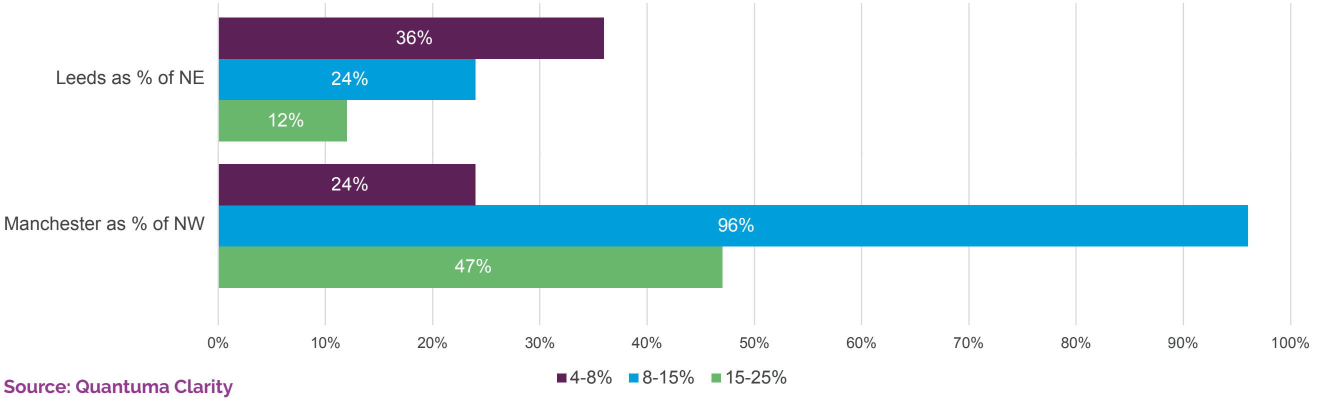
- Over 80% of affected employees in Leeds work in SMEs in the 4-8% category compared to 5% in the same category in Manchester. Similarly, whereas 95% of all affected employees in Manchester work in SMEs in the 8-15% category, for Leeds such employees amount for only 17%.
- Interestingly, whilst Leeds has 2% of employees working in SMEs in the most severely distressed 15-25% category, the equivalent figure for Manchester is marginally over 0%, despite the much larger number of SMEs. This suggests that the average number of employees per SME in the most severely distressed 15-25% category is higher than in the other two categories.
- In terms of distressed SMEs, those in Manchester account for 80% of all distressed businesses in the North West region, compared to 32% for Leeds relative to the North East.
- Within the 8-15% category, 96% of those SMEs are Manchester-based which is a very significant finding when compared to Leeds where the equivalent figure is 24%.

Jobs at risk: Over 80% of affected employees in Leeds work in SMEs in the 4-8% category compared to 5% in the same category in Manchester. 95% of all affected employees in Manchester work in SMEs in the 8-15% category, for Leeds such employees amount for only 17%.



Source: Quantuma Clarity

Number of distressed SMEs in Leeds and Manchester as a percentage of total distressed businesses in the North East and North West respectively.



Source: Quantuma Clarity

Acknowledgements

LAECEUM
STRATEGY I ADVISORY I DATA I ANALYTICS

Clarity has been created **in partnership with Laeceum**, an 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**

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

Robert Parry
Managing Director
Head of North West
Forensic Accounting & Investigations
+44 (0)779 289 5884
robert.parry@quantuma.com

Rehan Ahmed
Managing Director
Head of Yorkshire & North East
Restructuring & Insolvency
+44 (0)7891 347 817
rehan.ahmed@quantuma.com

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

Frank Ofonagoro
Managing Director
Financial Advisory
44 (0)746 985 9111
frank.ofonagoro@quantuma.com

Jeremy Woodside
Managing Director
Restructuring & Insolvency
+44 (0)780 061 7403
jeremy.woodside@quantuma.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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