SME HEALTH CHECK INDEX

Q2 2019

Clydesdale Bank
Yorkshire Bank

SEPTEMBER 2019

Compiled by Cebr,
in association with CYBG

CONTENTS

Authorship and acknowledgements

This report has been compiled by Cebr, an independent economics and business research consultancy established in 1992. The views expressed herein are those of the Cebr only and are based upon independent research by it.

The report does not necessarily reflect the views, financial position, business strategy or intentions of CYBG, its group companies, or its directors or employees. All lending decisions are subject to status.

London, September 2019

FOREWORD

Overall, the picture painted by the results in this quarter's Health Check Index was mixed. We saw a fall in the headline index to a historic low, from 48.8 in Q1 to 41.9 in Q2 2019, as businesses were tested by heightened uncertainty, moderating economic growth globally and rising costs. Declines were recorded across GDP, business lending and confidence indicators, amongst others.

While on the surface things may look a little gloomy, there is more to the findings than first meets the eye. Beyond the headline figure, the picture is complex, and cause for optimism can be found. Most notably, the labour market has remained resilient, with SMEs continuing to hire, and wages continuing to grow, despite the tougher conditions. Further, an analysis of workforce composition, customer base and supplier relationships has revealed some encouraging insights on SME diversity across many parts of the country, indicating a good ability to handle sudden change or shocks.

SMEs continue to face a testing environment

There is no denying, however, that SMEs faced a challenging environment in the second quarter. Political uncertainty reached new heights as Theresa May announced her decision to step down, throwing the direction of Brexit negotiations and likely UK departure date even further into the air. Meanwhile, global growth slowed, and international trade tensions escalated; China and the US remained firmly at loggerheads, with no resolution in sight. All of this contributed to a fall in business confidence, largely erasing gains recorded at the start of the year.

The largest drivers of the overall Index fall were the GDP and lending indicators. The UK economy contracted by 0.2% in Q2, the first quarterly contraction since Q4 2012. This was largely due to the drawing down of inventories accumulated ahead of the original 31st March Brexit deadline, declining business investment, as well as falling exports. In terms of lending, a 1.7% year-on-year decline in the value of SMEs' overdraft and loan balances was recorded, indicating continued caution, but also in line with reports of a fall in the availability of credit.

Further, business costs are up - something SMEs will need to carefully manage going forward. After two consecutive quarters of decline, the annual rate of business cost inflation edged up to 2.7%. The rise was primarily driven by labour costs. Looking at whether or not these increased business costs may now need to be passed on to customers, or can be covered through another approach, will need to be addressed.

Cause for optimism remains

Scores across employment, nonetheless, provide good cause for optimism. The total number of people in employment reached 32.8 million in Q2 2019 – 114,000 higher than in the first quarter of the year, and 425,000 higher than at the same point last year. Increased uncertainty, as well as wage growth, appear not to have deterred employers from hiring thus far.

Examining regional variation also contributes to a more positive picture. While the majority of regions examined saw declines in the overall index, many saw good performance across certain individual indicators. Furthermore, in contrast to the rest of the UK, Scotland and the South West of England each saw more than six point increases in their index scores. Scotland witnessed a good recovery across confidence and capacity indicators, while the South West saw a particularly strong performance on employment. Many regions scored well on diversity measures – with a good diverse product, supplier, customer and workforce mix, signalling good levels of resilience.

Looking forward

There are undoubtedly challenges ahead. However, here at CYBG we are committed to helping UK SMEs prosper and grow. We are optimistic that with a careful strategy and access to adequate support, businesses have the resilience to weather the storm. We are focused on meeting our lending commitments to the sector and hope to continue to work closely with SMEs going forward to navigate an increasingly complex landscape.

"There are undoubtedly challenges ahead. However, here at CYBG we are committed to helping UK SMEs prosper and grow. We are optimistic that with a careful strategy and access to adequate support, businesses have the resilience to weather the storm."

GAVIN OPPERMAN
Group Business Banking
Director

TAKING THE TEMPERATURE OF THE UK'S SME PERFORMANCE

Small and medium sized enterprises are the engine room of the UK economy.

60% of all private sector employment in the UK

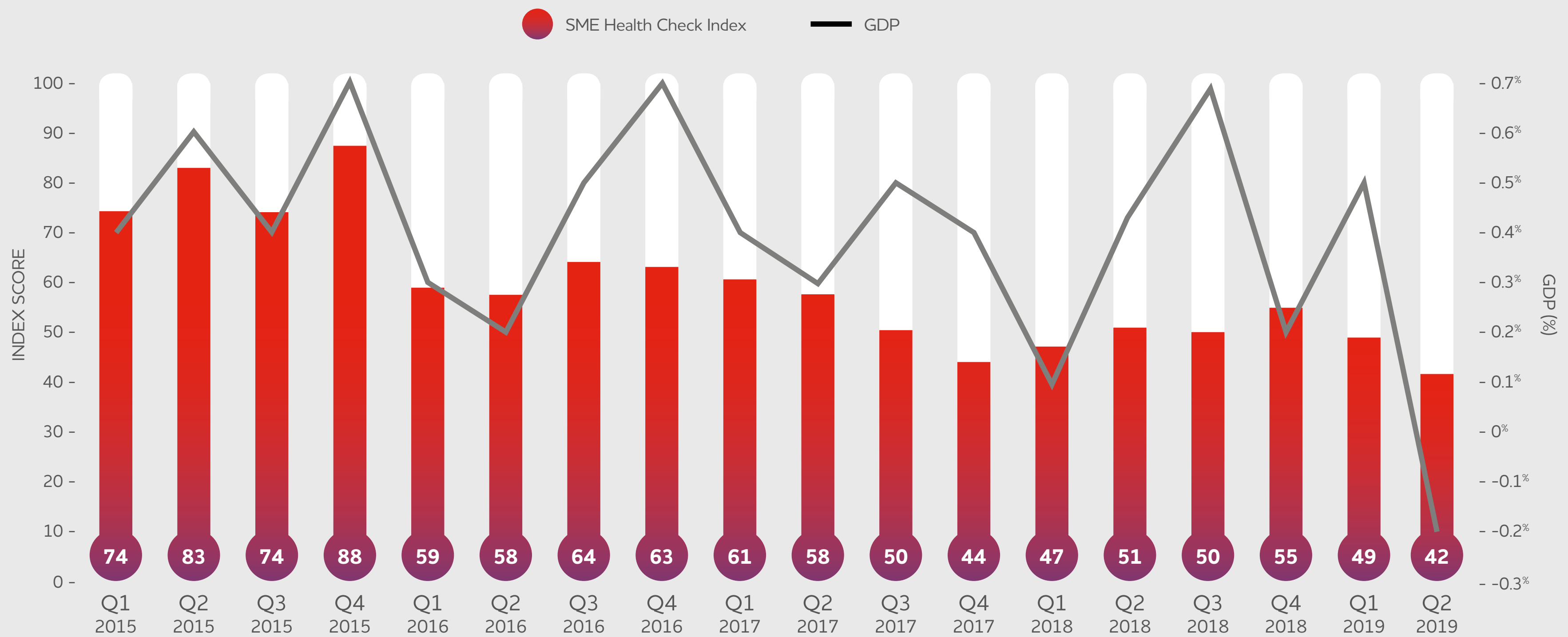
5.7 million private sector businesses

52% of all private sector turnover

SME HEALTH CHECK INDEX SCORE

41.9 Q2 2019

48.8 Q1 2019



CHANGES BELOW ARE COMPARED TO Q1 2019

Business Costs
65 (1↓)

GDP
53 (19↓)

Capacity
26 (11↓)

Lending
58 (18↓)

Confidence
24 (5↓)

Net business creation
12 (6↓)

Employment
73 (5↑)

Revenue
24 (0)

East Midlands
51.1 (0)

East of England
44.4 (2.4↓)

London
28.1 (17.8↓)

North East
48.6 (8.9↓)

North West
34.8 (4.5↓)

Scotland
41.9 (6.1↑)

South East
44.1 (3.8↓)

South West
41.0 (6.2↑)

Wales
52.5 (2.5↓)

West Midlands
28.5 (6.5↓)

Yorkshire and the Humber
39.9 (14↓)

↑Up ↓Down
From Q1 2019

As the lifeblood of the UK economy, SMEs are crucial to growth, driving employment and shaping the world of work.

EXECUTIVE SUMMARY

As the lifeblood of the UK economy, SMEs are crucial to growth, driving employment and shaping the world of work. SMEs account for at least 99.5% of businesses in every main industry sector and last year, it was found that in the private sector, 99.3% were small businesses. Of this, 99.9% were small or medium sized SMEs. This equates to 16.3 million people in employment and accounts for 60 per cent of all private sector employment in this country. Given that SMEs have a combined annual turnover of £2 trillion, they are a proven ingredient to a successful economy and it is vital that they are given the right tools and support to expand.

This quarterly report for CYBG, owner of Clydesdale and Yorkshire Banks, analyses the health of SMEs in the UK. The result of the analysis is the SME Health Check Index, which combines various statistics and indicators to evaluate the health of businesses and the macroeconomic environment within which SMEs operate. The SME Health Check Index takes on values between 0 and 100. A score of 100 would indicate that all of the SME Health Check Index's eight indicators are at their highest level since data collection began in 2014. A score of 0 would show that all of the eight indicators are at their lowest level since data collection began.

The Q2 2019 report finds that:

- The SME Health Check Index fell from 48.8 in Q1 to 41.9 in Q2 2019. This is the lowest score since the Index began recording data in 2014.
- Between Q1 and Q2, declines were recorded in every indicator with the exception of the employment indicator. Falling levels of business investment suggest that in the current climate, many firms are opting to expand their capacity through hiring rather than committing to longer term capital investment. The largest drivers of the overall fall in the SME Health Check Index were the GDP and lending indicators. This is in line with the first quarterly contraction of UK GDP in seven years and a continuation of political and economic uncertainty that has made many SMEs reluctant to borrow.
- The slowdown of the UK economy in Q2 2019 also fed into the capacity indicator, as the share of SMEs operating below capacity rose to a three-year high. Meanwhile, an array of factors ranging from slowing domestic and global growth, trade tensions and political uncertainty will have contributed to the 5 point fall in the confidence indicator.
- The labour market remained resilient in the second quarter of the year, as the annual rate of employment growth increased from 1.1% to 1.3%. This was driven in part by rising numbers of women entering the workforce, with the economic inactivity rate for women falling to a record low of 25.1% in Q2. However, the tight labour market has also led to a significant increase in wage inflation and hence employment costs. This factor was a major contributor to the slight worsening of the business costs indicator in Q2.
- Eight out of the 11 regions covered saw a decline in the SME Health Check Index in Q2 2019, driven by the widespread falls in the lending and GDP indicators. The largest declines were recorded in London and Yorkshire & the Humber, whose Index scores are both now at an all-time low. The SME Health Check Index for Yorkshire & the Humber was severely impacted by the 28,000 fall in the number of people employed in the region, which made it the only part of the UK to register a negative annual rate of employment growth in Q2. The closure of Yorkshire based chains such

as the Filmore and Union café chain and the Yorkshire Linen Company contributed to the wider decline in regional employment in the second quarter of 2019.

- In contrast to the rest of the UK, Scotland and the South West of England each recorded a more than six point increase in their respective SME Health Check Index scores. Scotland's score for the second quarter was bolstered by a recovery of confidence. This may be linked to a fall in the share of SMEs operating below capacity, suggesting that the wider economic slowdown was less pronounced in Scotland than elsewhere in the country. Meanwhile the South West saw a substantial increase in employment between Q1 and Q2 which boosted its latest SME Health Check Index score.
- The special report for this quarter's Health Check Index on SME complexity finds that the West Midlands and Yorkshire & the Humber are the regions in which businesses are most evenly spread across different industries. At a city level, Leeds and Leicester stand out as the cities with the most balanced economies.
- Along the dimensions of product complexity and workforce diversity, London outperforms the rest of the UK, with SMEs on average reporting that nearly a third (31%) of their workforce are from Black, Asian or other ethnic minority backgrounds.
- Yorkshire & the Humber is also the region with the most complex basket of export goods, which is facilitated by its diverse pool of businesses that operate across a range of sectors. London also scores highly in the goods export complexity measure, which likely understates the true complexity of the capital's export base given the importance of services to the London economy.

8/11

regions saw a decline in their Index scores

↑6.1

point increase in Scotland

1. UK MACROECONOMIC ENVIRONMENT

The UK economy suffered its first quarterly GDP contraction in seven years in Q2 2019. To some extent, this was a hangover from the flurry of stockpiling activity that took place ahead of the original 31st March Brexit date, leading to the accumulated inventories being drawn down during the subsequent months.

The second quarter of the year represented a period of political limbo for the UK, after Theresa May announced her intention to step down as Prime Minister and a plethora of candidates jostled for position at the helm of the Conservative Party. The continued uncertainty meant that business sentiment remained heavily subdued, as business investment fell by 0.5% between Q1 and Q2 – the fifth quarterly contraction in the past 18 months.

While the fall in economic output in Q2 immediately sparked fears of a more prolonged period of contraction, the latest figures do contain a silver lining: consumer spending has been resilient so far in 2019, with household expenditure growth of 0.5% in Q2 standing in stark contrast to the 0.2% contraction in overall GDP. As economic and political uncertainty continue to curb business investment and moderate global growth and trade tensions weigh on exports, the burden of staving off a technical recession (two consecutive quarters of negative growth) will fall to a large extent on the shoulders of consumers.

With this in mind, it is encouraging that the labour market has remained robust in recent months. The employment rate reached a joint record high of 76.1% in Q2 2019, while average earnings rose by 3.7% year-on-year – the fastest growth rate in 11 years. However, high levels of household debt have driven many to reassess their borrowing, with the annual rate of consumer credit growth slipping to 5.5% in June compared to a high of 10.9% in November 2016. This, together with weak levels of consumer confidence, will limit the degree to which households are able to power the economy forward in the coming quarters.

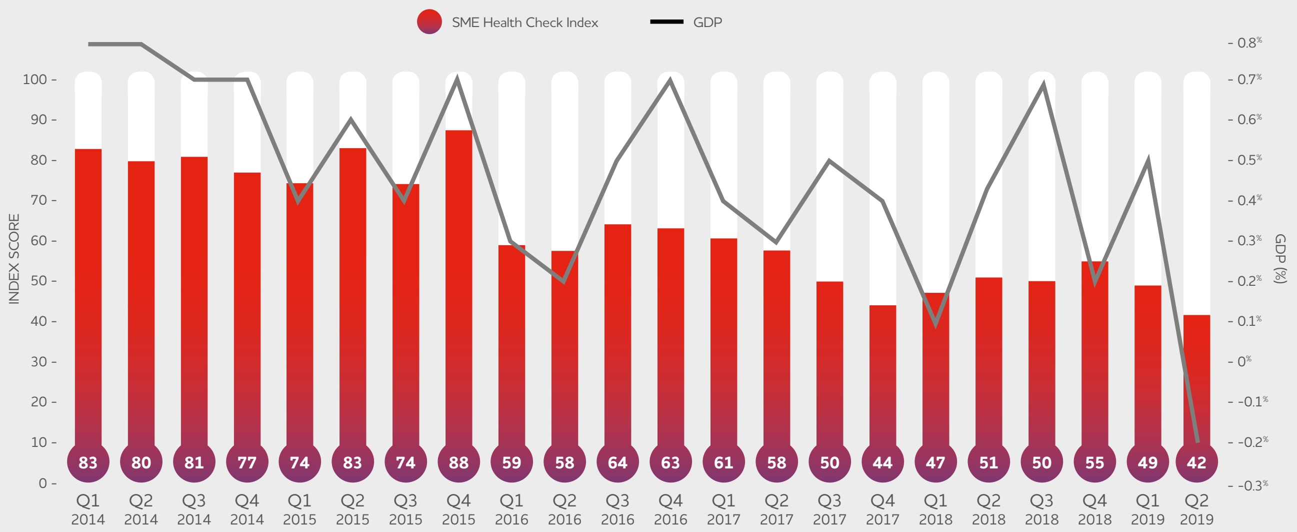
Under any circumstances, the UK's imminent departure from the European Union would represent a challenging time, given the inevitable disruption this will bring to what have become closely integrated economic, political and regulatory systems. However, the scheduled Brexit date of 31st October – which the UK Government maintains is a hard deadline for departure – comes at an acutely difficult time for the global economy, with significant slowdowns taking place in major economies such as China, Germany and India, against the backdrop of escalating trade tensions and geopolitical uncertainty.

2. SME BUSINESS HEALTH FALLS TO RECORD LOW IN Q2 2019

SMEs represent the growth engine of our economy. SMEs represent 52% of all private sector turnover, and their success is crucial to the security of millions of jobs and the development of countless UK sectors. We are not only analysing different variables that can be directly linked to the performance of SMEs, such as confidence and revenue, but also the business and macroeconomic environment in which SMEs operate. The following section begins by presenting the overall results of the SME Health Check Index and its indicators, before turning to regional comparisons.

The SME Health Check Index dipped sharply to 41.9 in the second quarter of 2019, taking the index to its lowest level since data collection began in 2014. The 6.9 point fall between Q1 and Q2 also marks the largest quarterly fall in nearly two years. Declines were registered in all of the indicators with the exception of the employment indicator, as the labour market continues to exhibit resilience despite the weakening state of the overall economy. The 0.2% GDP contraction in Q2 led to a dramatic fall in the corresponding indicator, while the economic slowdown has also had an effect on the share of SMEs operating below capacity, which rose for the second consecutive quarter. Meanwhile, political and economic uncertainty, in addition to a deteriorating global outlook continue to weigh on business confidence, which is reflected in the declines registered in both the SME confidence and lending indicators. The following section analyses the indicators of the SME Health Check Index in more detail.

FIGURE 1: SME HEALTH CHECK INDEX



Business Costs

The annual rate of business cost inflation inched up by 0.1 percentage points to 2.7% in Q2 2019. This increase was driven largely by an uptick in the rate of wage growth, with the annual growth rate of average earnings climbing to an 11 year high in the three months to June. Helping business costs in the second quarter of 2019 were falling commercial rents, as well as a significant slowdown in the rate of price growth for key physical inputs such as chemicals and metals.

Capacity

The share of SMEs operating below capacity edged up in the second quarter of the year, in line with the contraction in overall output. This marks the second consecutive quarter that the capacity indicator has fallen. This is a concerning finding and suggests that beneath the volatility of headline GDP figures brought about by stockpiling activities either side of the original 31st March deadline, levels of activity in the economy have begun to slow so far in 2019.

Confidence

According to the Federation of Small Businesses' (FSB) Voice of Small Business Index[1] , business confidence in Q2 2019 fell back towards the level seen at the end of 2018, largely erasing the modest gains recorded at the start of the year. Although the successive extensions of Article 50 allayed fears in the immediate term of a disorderly Brexit, they did little to provide clarity to businesses on the nature of the UK's future relationship with the EU. Global factors will also have weighed on sentiment in Q2, such as the intensification of tensions between the US and China and a more general slowdown in major economies across the world.

Employment

The total number of people in employment reached 32.8 million in Q2 2019 – 114,000 higher than in the first quarter of the year, and 425,000 higher than at the same point last year. This equates to an annual growth rate of 1.3%, which pushed the employment indicator up to 73.

Economic and political uncertainty, as well as accelerating wage growth appear not to have deterred employers from hiring thus far, although declining numbers of vacancies and a slight uptick in the unemployment rate suggest that some cracks are beginning to show in the labour market.

GDP

The UK economy contracted by 0.2% in Q2 2019 – the first quarterly contraction since the final quarter of 2012. The fall in economic output was largely attributable to a decline in business investment, the drawing down of inventories accumulated ahead of the 31st March Brexit deadline, as well as a sharp deterioration of exports, brought about by slowdowns among key trading partners and a broader decline of global trade volumes. One part of the economy that did perform well was the household sector, with consumer spending rising by 0.5% between Q1 and Q2 – a likely result of high levels of employment combined with improving wage growth.

Lending to SMEs

The lending indicator dropped to a 15-month low of 58 in the first quarter of 2019 (the latest quarter for which data are available), as the value of SMEs' overdraft and loan balances fell by £113 million compared to the level in Q4 2018. This equates to a 1.7% year-on-year decline. The results of the Bank of England's Credit Conditions survey from Q1 2019 suggest that is attributable predominantly to a fall in the demand for credit from small businesses. However, lenders in the survey also reported a slight decline in the availability of credit, citing a changing appetite for risk as the main cause for this. This indicates that the uncertain political and economic outlook continues to lead to caution among SMEs with regards to their borrowing activity.

1 Federation of Small Businesses: Voice of Small Business Index – Q1 2019

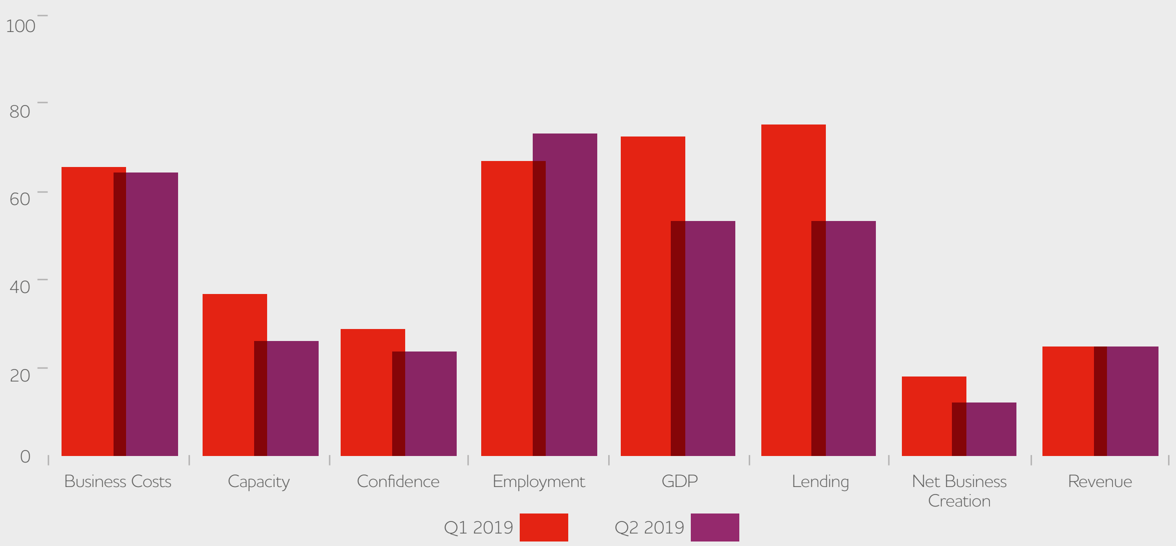
Net Business Creation

The number of new companies incorporated in Q2 2019 was just under 170,000, compared to 182,742 in the first three months for the year. This fall brought down the annual rate of business creation to 4.0% in Q2 2019, generating an indicator score of 12. The volatile economic environment will have deterred some from starting new businesses, although it is encouraging to note that the rate of business creation remains higher than it was through much of 2018.

Revenue

Data for the revenue indicator are available every six months, so this indicator remained at the relatively weak score of 24 in the second quarter of 2019. Nevertheless, retail sales have consistently exceeded expectations in recent months. Indeed, in the year to June, the volume of retail sales rose by an impressive 3.8%. Meanwhile, consumer spending also increased by 0.5% in real terms between Q1 and Q2 2019. These figures should have supported SMEs' revenues during the second quarter of the year, although the challenging economic conditions generally are likely to have constrained any more significant gains in this indicator.

FIGURE 2: SUB-COMPONENTS OF THE SME HEALTH CHECK INDEX (SOURCES: FSB, ONS, BBA, CEBR ANALYSIS)



2.1 REGIONAL BREAKDOWN OF THE SME HEALTH CHECK INDEX

While the previous section of the report analysed the indicators of the SME Health Check Index across the UK as a whole, this section investigates regional differences in order to understand which parts of the UK currently present a more favourable business and macroeconomic environment for SMEs. We divide the UK into the nine English government office regions (East Midlands, East of England, London, North East, North West, South East, South West, West Midlands and Yorkshire & the Humber), as well Scotland and Wales.

Eight out of the 11 regions covered registered declines in the SME Health Check Index in the second quarter of the year, in line with the sharp fall in the overall Index. The most precipitous declines were recorded in London and Yorkshire & the Humber, where the Index is now at its lowest since data collection began in 2014. This was also the case in the West Midlands, despite a less dramatic 6.5 point fall in the SME Health Check Index in Q2 2019. Scotland and the South West of England bucked the national trend, each recording more than 6 point gains in the SME Health Check Index in Q2 following significant falls the previous quarter.

FIGURE 3: REGIONAL SME HEALTH CHECK INDEX (SOURCES: FSB, ONS, BBA, CEBR ANALYSIS)

East Midlands

The East Midlands was one of only three regions in the UK not to see a fall in the SME Health Check Index in the second quarter of 2019. Between Q1 and Q2, the Index remained stable at 51.1. The region did not escape the fallout from the economic slowdown felt throughout the UK, with significant falls recorded in the capacity and GDP indicators. However, the number of people employed in the region rose by nearly 18,000 during the second quarter, which drove the annual rate of employment growth to 3.1% - the fastest rate in the UK and more than double the rate recorded in Q1 2019. There was also a sizeable improvement in the lending indicator, which rose from 0 in Q1 to 45 in Q2. However, the value of SMEs' outstanding loans and overdrafts continued to decline on an annual basis in the first quarter of 2019. There are a slew of regeneration schemes in the pipeline for major cities in the region, which promise to provide a boost to economic activity in the short to medium term, while unlocking productivity gains in the longer term. These schemes include the Southside regeneration project in Nottingham – which includes the construction of a new bus station and shopping centre – and plans for a sustainable urban area in the north east of Leicester.

East of England

The SME Health Check Index fell by 2.4 points to 44.4 in Q2 2019, a less dramatic decline than seen elsewhere in the UK. Falls in the capacity, confidence, business creation and GDP indicators were offset to a large degree by the lending indicator, which rose by 50 points to 76 in the second quarter of the year. The value of the region's SMEs' outstanding loan and overdraft balances edged up by £8 million between Q4 2018 and Q1 2019, meaning that the annual growth rate rose from -12% to 0%. The annual rate of employment growth in the East of England fell from 2.4% in Q1 to 1.8% in Q2, dragging down the corresponding indicator to 71. The construction sector – a key part of the region's economy – was one of the worst performing in the second quarter of 2019, contracting by 1.9%. The announcement by Sandy-based Kier group of 1,200 job cuts represents a significant blow for employment throughout the East of England.

London

London was the region with the greatest deterioration of the business environment in the second quarter of 2019, as the SME Health Check Index fell by 17.8 points to 28.1. This is – by a considerable margin – the lowest the Index has been since data collection began five years ago. Indeed, the next weakest quarterly Index score was 39.8, recorded in Q4 2017.

The decline was driven by sharp falls in the GDP and confidence indicators, which are also now at their lowest level since the Index began. The share of SMEs operating below capacity also jumped significantly. The fact that the services sector – a dominant component of London's economy – narrowly avoided entering negative growth in Q2 2019 could provide some hope that the capital was able to escape the worst of the economic slowdown. However, the deterioration of the capacity indicator suggests that this was not the case.

At the end of 2018, London was one of only two regions in which the value of SMEs' outstanding loan balances had increased year on year. However, in Q1 2019 the value of outstanding loan balances was £357 million lower than it was at the same point the previous year. The weak performance of the lending, confidence and capacity indicators suggest that SMEs in the capital have grown increasingly wary of both the longstanding and emerging risks in the business environment.

London's workforce is among the most reliant on foreign workers in the UK. Indeed, nearly 15% of those employed in the capital are EU citizens, compared to a nationwide average of less than 7%. Therefore, any restrictions to the free movement of people between the UK and the EU would have significant ramifications for many of London's businesses. London accounts for a higher share of economic output than any other region, and the deterioration of the business environment in Q2 is therefore a key concern for the country as a whole given the capital's ties with other parts of the UK.

North East

The SME Health Check Index for the North East of England fell by 8.9 points to 48.6 in Q2 2019, which is the lowest the Index has been since Q3 2018. This decline was fuelled largely by the confidence and GDP indicators, which fell to 31 and 42 respectively.

The automotive sector is a highly significant industry for the North East, which hosts an array of international car manufacturers. In recent months, threats to this sector have intensified significantly, ranging from the disruption to supply chains associated with a disorderly Brexit, to global trade tensions and economic slowdowns in key markets. For instance, India – often touted as a major source of growth for the vehicle market given the huge population and rising incomes – saw a 31% annual decline in vehicle sales in July. Structural shifts within the vehicle market will also be a concern for the North East. In particular, the increasing numbers of consumers in both advanced and developing economies opting for ride sharing services ahead of purchasing their own vehicle represents a major threat to the automotive sector going forward. A more encouraging development for SMEs in the North East is a fall in the rate of business cost inflation for manufacturing firms. This was largely a result of a significant slowdown in the rate of inflation for physical inputs such as metals and chemicals.

North West

The North West saw a 4.5 point fall in the SME Health Check Index, bringing the score down to 34.8 in Q2. In contrast to the national trend, the annual rate of employment growth in the region dipped by 0.3 percentage points to 1.0%, bringing down the employment indicator to 51.

The lending and confidence indicators also registered small declines in Q2, although this was partially offset by an improvement in the capacity indicators. The North West of England is among the largest would-be beneficiaries of the HS2 scheme, given the potential for greater integration with major urban centres both to the south (London and Birmingham) and the north (Leeds). The outcome of the government's recently announced review into whether the scheme goes ahead will have significant implications for the economy of the North West in the medium to long term.

Scotland

The SME Health Check Index for Scotland rose by 6.1 points to 41.9 in Q2, largely recovering the losses recorded in the first quarter of the year. This increase is the second highest in the UK, behind only the South West of England.

The main drivers of the improvement in the SME Health Check Index were the confidence and capacity indicators, which bounced back in Q2 following their fall to historic lows the previous quarter. Despite the encouraging developments in these indicators, there are still causes for concern. At 0.6%, the annual rate of employment growth in Scotland is among the lowest in the UK, while the annual rate of business creation fell by 0.2 percentage points to 3.9% in Q2.

Although the unemployment rate in Scotland has ticked up (from 3.2% in Q1 to 3.6% in Q2 2019), it remains below the UK average. The strength of the labour market in Scotland has been key to the performance of the local economy. Low unemployment also has fiscal implications: the latest data show that Scotland's onshore tax revenues (excluding those from North Sea oil) rose by £3 billion to £62.7 billion in the 2018/19 financial year – which is a positive indicator for levels of activity in the local economy.

South East

The South East experienced a 3.8 point decline in the SME Health Check Index, taking the score to 44.1 in the second quarter of 2019. This is despite a more than 52,600 person increase in employment between Q1 and Q2, which brought the annual rate of employment growth to 2.5% - the second highest in the UK. There was also a slight fall in the share of SMEs operating below capacity in Q2, indicating that the recent slowdown in economic activity may have been less pronounced in the services-oriented economy of the South East.

While other parts of the UK have embraced co-ordinated, regional approaches to economic development – such as the Northern Powerhouse and the Midlands Engine – a similarly cohesive agenda does not yet exist for major cities in the South of England. If successful, enterprises such as Business South – which aims to promote investment and employment in the region – have the potential to unlock significant productivity improvements in the coming years via increased regional and national connectivity and inward investment.

South West

The SME Health Check Index rose by 6.2 points in the South West, in stark contrast to the performance of most regions in Q2. SME sentiment improved marginally in the second quarter, bringing the score for the corresponding indicator up to 27.

There was also a 36,400 increase in employment between Q1 and Q2, which more than doubled the annual rate of employment growth in the South West from 0.9% to 2.0%. Business West – one of 53 accredited Chambers of Commerce authorised to certify Certificates of Origin for UK exporters – recently announced that it certified a record number of export documents in July, signalling that export activity in the region is proving resilient despite the challenging domestic and external conditions. These results are an encouraging sign for the regional economy and the health of its SMEs.

Wales

Unlike much of the rest of the UK, Wales saw a decline in the employment indicator in Q2 2019, alongside improvements in the confidence and lending indicators. The net effect of these changes was a 2.5 point fall in the SME Health Check Index in the second quarter of 2019, bringing the score down to 52.5. While the value of Welsh SMEs' outstanding loan and overdraft balances in Q1 2019 was marginally below the value at the same time the previous year, the annual rate of contraction was the lowest since 2015.

Meanwhile, sentiment among SMEs is now more positive in Wales than in any other part of the UK. Despite the relative optimism of Welsh businesses, productivity remains a major challenge for the local economy. A recent study by Durham University has found that total factor productivity – which reflects the efficiency with which an area's labour and capital are deployed in production – is more than twice as high in London as it is in Wales. Another potential obstacle to growth for Wales in the coming years will be the shortfall in funding that will result from the UK's withdrawal from the EU. Boris Johnson's promise to Wales of a share of £300 million in funding for devolved nations over 15 years will cover only a small share of the amount the nation currently receives from EU structural funds. These funds would no longer be available to the UK in the years after its withdrawal from the EU, meaning that Wales could be on course to lose out if the UK government opts not to address this shortfall.

West Midlands

The SME Health Check Index for the West Midlands fell by 6.5 points to 28.5 in Q2 2019. This is the lowest since the Index started collecting data in 2014. The decline was led by the capacity indicator, with the share of SMEs operating below capacity increasing to a record high. Meanwhile, the annual rate of employment growth fell to 0% in Q2 – a far cry from the 4.6% at the same point last year. The West Midlands will be among the regions most hit by the slowdown of the manufacturing industry, which is attributable to a myriad of factors ranging from the drawing down of accumulated inventories, slowing growth in key export markets, global trade tensions, and continued uncertainty surrounding Brexit.

The increased likelihood of a no-deal Brexit will be a concern for many manufacturers in the region, that are reliant on the swift movement of goods across the channel, as well as access to the European market. Boris Johnson's support for plans to expand Birmingham's metro network will have positive implications for productivity in the longer term. However, the recently announced review into HS2 has placed fresh doubt on the future of this scheme – which the West Midlands would be a major beneficiary of.

Yorkshire & the Humber

Yorkshire & the Humber saw a dramatic 14 point decline in the SME Health Check Index for Q2 2019, bringing the score down to 39.9. This was largely attributable to a significant increase in the share of SMEs in the region that were operating below capacity, as well as a more modest decline in business confidence. Moreover, the number of people in employment in Yorkshire & the Humber fell by nearly 28,000 between Q1 and Q2, meaning that this region is now the only part of the UK where employment numbers are declining year-on-year.

The closure of Yorkshire based companies such as the Yorkshire Linen Company and the Filmore and Union Café chain contributed to this overall drop in employment. The employment outlook for the region did receive a boost in August when Turkey's military pension fund entered talks to take over British Steel, which employs thousands in the local area. However, the sharp fall in the SME Health Check Index suggests that SMEs in Yorkshire & the Humber have been badly impacted in Q2 by the wider economic slowdown and the volatility of the current political and economic environment.

14↓

point decline in

Yorkshire & the Humber

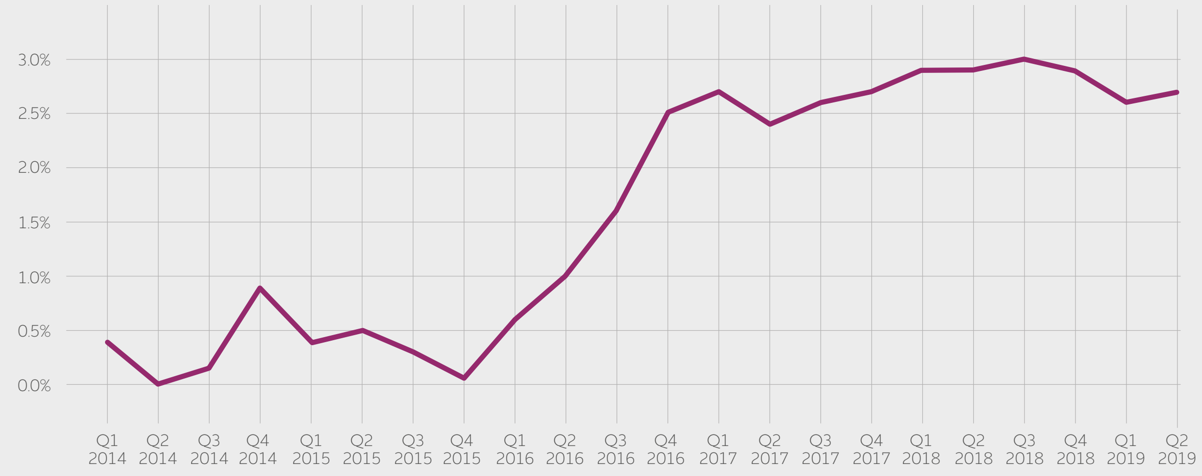
↑6.2

increase in the South West

3. IN FOCUS: SME BUSINESS COSTS INFLATION

In this section, we explore the business costs indicator in greater detail in order to examine the cost pressures faced by SMEs during the second quarter of 2019, and the degree to which rising input prices have affected businesses in different industries and regions.

FIGURE 4: SME INFLATION Q1 2014 – Q2 2019



After two consecutive quarters of decline, the annual rate of business cost inflation stabilised in the second quarter of 2019, edging up by 0.1 percentage points to 2.7%. The primary driver of this increase has been employment costs: according to ONS data, average weekly earnings (including bonuses) in the UK rose to £538 in June, up from £530 at the end of the Q1 2019. At 3.7%, the annual rate of earnings growth is now the highest its been in 11 years. While rising household incomes are key to sustaining economic growth – particularly in the current climate of subdued investment and weak export figures – this also places a significant strain on employers. This is particularly true given the UK's persistently poor productivity growth. Indeed, output per hour worked was 0.6% lower in Q2 2019 than in the same quarter last year.

Over the course of the second quarter, the pound has depreciated by around 3.5% against the euro and by 3.2% against the US dollar, reflecting investors' concerns about the growing prospect of a disorderly Brexit. These movements would likely have been even more pronounced were it not for the increasingly dovish tone adopted by both the US Federal Reserve and to a lesser extent the European Central Bank. The weakness of the pound will have pushed up import costs last quarter, although the full effects of this on prices are likely to be felt further down the road.

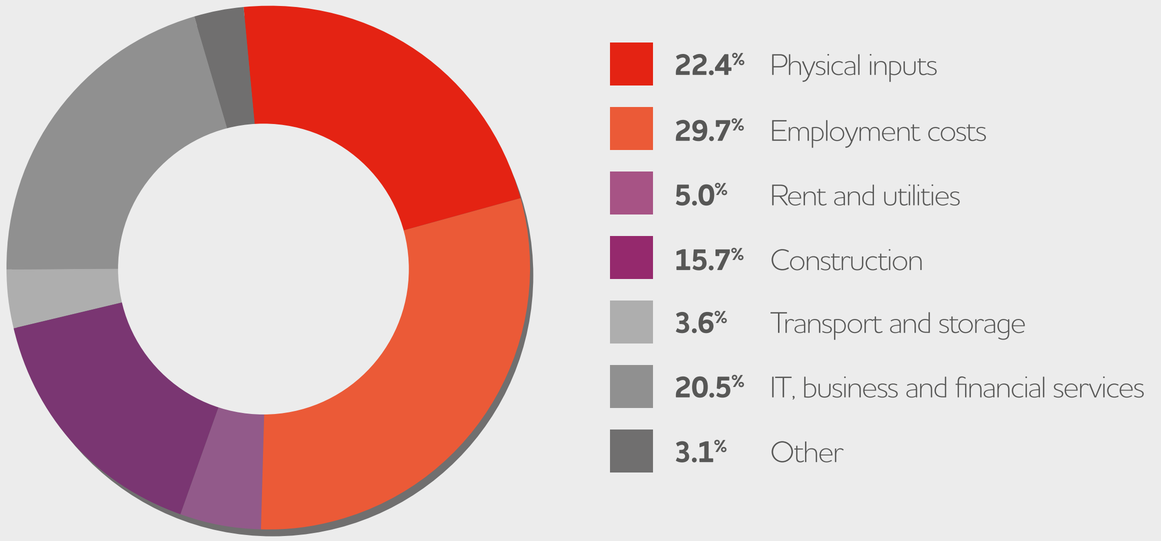
Cost pressures on SMEs will have been eased somewhat by a continued decline in the annual rate of inflation for commercial rents, which entered negative territory in Q2 for the first time since data collection began five years ago. A survey of 700 chartered surveyors carried out by the Royal Institution of Chartered Surveyors (RICS) found that most in the industry believe that demand for commercial property was falling rather than rising in Q2. The prospects for retail rental prices were particularly weak, although survey respondents were more bullish on the outlook for industrial property rents. The surge in stockpiling activity that took place in the first quarter of the year has led to a shortage of storage space in some areas, which will have pushed up the costs of certain types of commercial property in recent months.

While the annual rate of consumer price inflation (including owner occupier housing costs) has fallen back since the start of 2018 (reaching a low of 1.8% in January 2019 before inching up to reach 2.0% in July), the annual rate of business cost inflation has been above 2.6% throughout this period. The fact that business costs have been rising at a faster pace than consumer prices suggests that firms have been bearing the brunt of cost increases, rather than passing these on to their customers. While the scope to do this may have existed following the surge in input prices associated with the depreciation of the pound following the EU referendum in 2016, firms' ability to absorb further rises in input costs is far more limited today. This means that any spike in import costs resulting from a potential depreciation of the pound following a 'no-deal' Brexit would likely lead to sharp rises in consumer prices.

The relatively modest 0.1 percentage point increase in overall business cost inflation in Q2 masks some significant movements within industries. In the manufacturing sector, a sharp fall in the rate of inflation for key physical inputs such as metals and chemicals pushed down the annual rate of cost inflation to 2.6% - down from 3.1% the previous quarter. Meanwhile, an acceleration of price growth for business services such as advertising, marketing and freight transport meant that the annual rate of cost inflation for the retail sector jumped up from 2.4% in Q1 to 2.7% in Q2. Turning to business services, the labour-intensive nature of this sector meant that rising employment costs pushed up the annual rate of business cost inflation from 2.8% to 3.0%. These movements mark a significant shift in the industry-level variation of cost pressures: whereas in past quarters, industries with a high reliance on physical inputs such as manufacturing and construction faced the fastest rates of cost increases, the recent recovery of earnings growth has meant that firms in the services sector are now experiencing a more rapid rate of cost inflation.

The recent convergence of business cost inflation between industries has also eroded much of the regional variation in the rate at which businesses' costs are rising. In the second quarter of 2019, all regions with the exception of Wales had an annual rate of business cost inflation of 2.7% - in line with the UK average. In Wales' case, the relatively high share of activity that takes place outside of the services sector meant that the annual rate of cost inflation fell by 0.2 percentage points to 2.6% in Q2.

FIGURE 5: BREAKDOWN OF COSTS FACED BY SMES



4. SPECIAL REPORT: SME COMPLEXITY

Complexity and diversity – both within and across SMEs – are key components of the health of the overall business population in an area and can be highly beneficial to the local economy. The special chapter for the latest SME Health Check Index focuses on the theme of SME complexity, and how this varies in cities and regions across the UK.

To examine levels of complexity and diversity among local business populations, the following elements have been analysed:

- **Diversity of business population:** having a broad mix of SMEs across a range of sectors means that the local economy is less exposed to disruptions or shocks in a particular market or industry, allowing for more stable rates of employment and growth. This is evidenced by the volatile swings in the economic fortunes of oil-dependent nations as oil prices fluctuate, as well as the hardship brought upon communities by the loss of specific businesses or sectors that had previously dominated the local economy.[2]
- **Complexity of export basket:** the complexity of the products that a region exports is reflective of the level of knowledge and human capital contained within an economy. The complexity of an export basket is driven by the diversity of products in the basket, in addition to the rarity of these goods. In theory, regions reveal their areas of comparative advantage through the industries where they export more products than would be expected given the region's size and export propensity. For instance, in Q1 2019, beverages accounted for 12% of Scotland's goods exports, while for the UK as a whole, beverages made up just 2% of exports. The fact that beverages occupy a six times larger share of Scotland's export basket than they do the UK's indicates that Scotland has a comparative advantage in this area.

  Generally, comparative advantages are driven by localised factors such as infrastructure, capital and the availability of certain skills in the labour force. For the purposes of this report, we consider a region to have a complex export basket if it has several areas of comparative advantage and if only few other regions are specialised in these products. A complex export basket is widely regarded as a strong predictor of future growth.

2 To measure the extent to which an area's business population is spread across a range of diverse industries, a Herfindahl-Hirschman Index (HHI) has been constructed using local authority level data from the Inter-Departmental Business Register (IDBR). The HHI score measures diversity by calculating the share of a city's businesses that operate in each industry. The HHI score corresponds to the sum of the square of these percentages, with high scores corresponding to low levels of business diversity.

The benefits of diversity and complexity also extend to individual businesses. In order to gain an insight into levels of diversity within SMEs in different parts of the country, a survey of senior decision makers from 1,002 businesses has been commissioned[3]. This has facilitated an analysis of the following aspects of SME diversity:

- **Product & sectoral diversity:** SMEs whose activities are less concentrated across a small number of markets or products are often more resilient in the long term to shifts in consumer preferences or other market-specific developments. The risks of focussing too heavily on a limited range of products are apparent even for very large companies. For instance, Nokia's share price has fallen precipitously from its peak in 2007, largely due to the spread of smartphones that eroded demand for its own product range. Even today, Nokia's stock price is around six times lower than it was in 2007. Comparable consumer electronics companies such as Sony also saw a decline in the demand for their mobile phones during this period. However, a more diverse product offering meant that the impacts of a lower market share in mobile phones were far more manageable.

- **Customer diversity:** Businesses with a more diverse customer base are in a better position to manage the loss of individual clients than those that rely very heavily on a small number of large customers.

- **Supplier diversity:** Looking up the supply chain, SMEs with a range of suppliers are less likely to experience a major disruption to their operations than those that are dependent on a single large supplier that cannot easily be replaced. A large part of the dramatic slowdown in economic activity that took place during the 'Beast from the East' in Q1 2018 was due to disruptions to supply chains associated with the various transport difficulties. This case illustrates the importance of having a diverse range of suppliers to minimise the risks of major operational disruptions.

- **Geographical diversity:** Establishing a presence across multiple sites and geographies makes businesses less vulnerable to disruptions that could occur at a specific location, which could range from natural hazards such as flooding to transport problems.

- **Workforce diversity:** This captures how balanced a company's workforce is along the dimensions of ethnicity, gender and age. High levels of diversity within a workforce exposes businesses to a broader range of influences, approaches and skills that can benefit a company's performance and workplace environment. Prior research by Cebr has found that businesses with the most gender diverse workforces are 4 percentage points more likely to have a productivity that is above the industry average than those with the least gender diverse workplaces. Similarly, the most ethnically diverse workforces are 12 percentage points more likely to achieve this than the least ethnically diverse workplaces.[4]

The above measures of business complexity and diversity have been calculated at a city or regional level, depending on the availability of data. For each measure, the regions and cities have been assigned a score of 0 to 100, where 0 represents a low level of complexity and 100 represents a high level of complexity.

The remainder of this chapter discusses the findings of the research into SME complexity and diversity for each of England's nine regions, Scotland, and Wales.

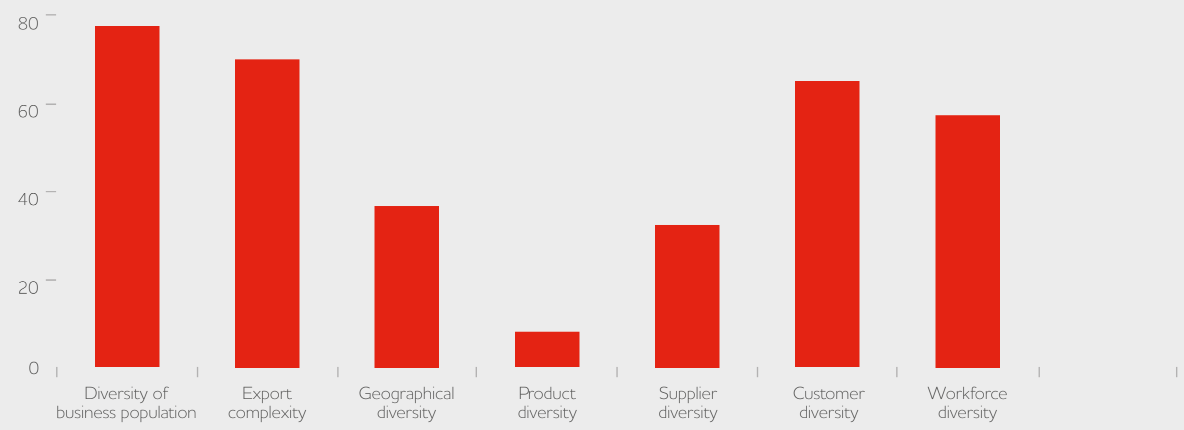
3 Survey carried out with 1000 key SME decision makers by Censuswide between 5th August 2019 and 21st August 2019.

4 https://www.out-standing.org/wp-content/uploads/2018/02/The-Value-of-Diversity-INvolve-x-Cebr-V1.pdf

East Midlands

With the exception of Leeds, Leicester – the largest city in the East Midlands – scores higher than any other city covered in the business population diversity indicator. Leicester's major manufacturing base supports the diversity of the business population, as does a more balanced spread of firms across different parts of the services sector, ranging from financial services to human health & social work activities.

FIGURE 6: SME COMPLEXITY MEASURES, EAST MIDLANDS (INTER-DEPARTMENTAL BUSINESS REGISTER (IDBR), HMRC, CENSUSWIDE)



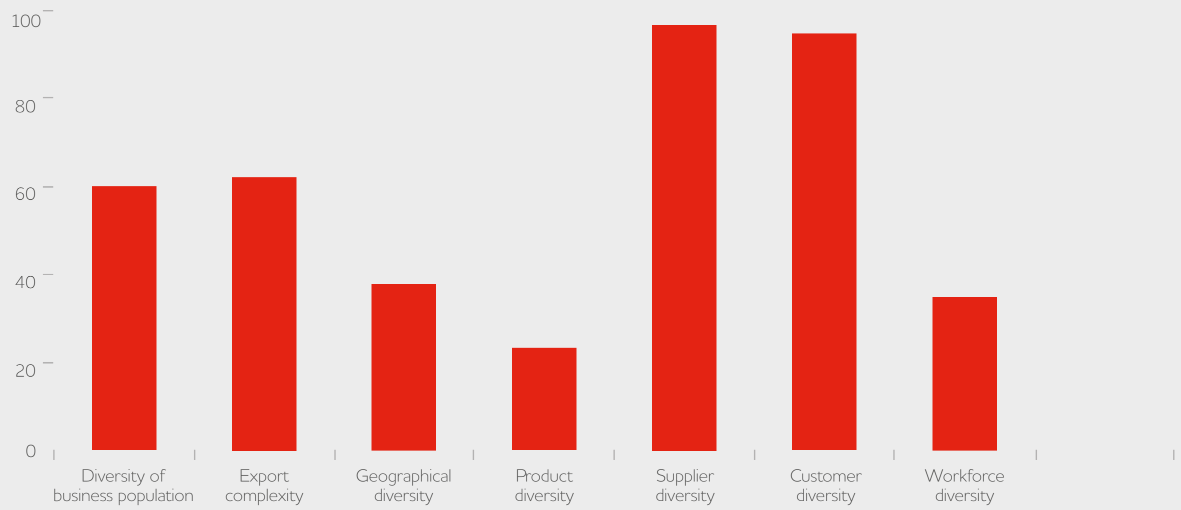
Nottingham also scores well on the measure of the diversity of the local economy, boosted by a major presence in the manufacturing and construction sectors. However, the score for the product diversity measure is the joint lowest in the UK. Indeed, the majority (62%) of SMEs surveyed indicated that most of their business' sales were attributable either to a single product or service (33%) or a small number of closely related products or services (28%). This finding extends more broadly to the rest of the East Midlands. This suggests that while the region has been successful in fostering a wide range of economic activities, many SMEs are highly dependent on relatively narrow product offerings that leaves them vulnerable to changes in market conditions or consumer preferences.

The East Midlands ranks third out of the UK regions analysed for the complexity of its goods export basket. Power generation machinery stands out as the region's largest export and is one of the East Midlands' key strengths. Other areas of revealed comparative advantage include the production of footwear, pulp and wastepaper.

East of England

SMEs in the East of England score the highest in the UK along the measure of supplier diversity. While the number of different suppliers or sub-contractors used by businesses over the past 12 months is broadly in line with the UK average, SMEs in the East of England are less dependent on any one single supplier. More than a third (37%) of SMEs surveyed indicated that in the event of a termination of their business relationship with their most important supplier or sub-contractor, they could replace this supplier within a week. This share is considerably larger than in any other part of the UK. Given the apparent fragility of many SMEs' supply chains in the region, the potential supply chain disruption associated with Brexit is a key concern. This is reflected in the fall in the confidence indicator for the East of England in Q2, which – alongside the GDP indicator – drove the overall decline in the SME Health Check Index.

FIGURE 7: SME COMPLEXITY MEASURES, EAST OF ENGLAND (IDBR, HMRC, CENSUSWIDE)



SMEs surveyed in the East of England are also less reliant on a handful of large customers than elsewhere in the UK. On average, just over a third (34%) of businesses' revenues over the past 12 months have come from their three largest customers or clients, compared to 38% for the UK as a whole.

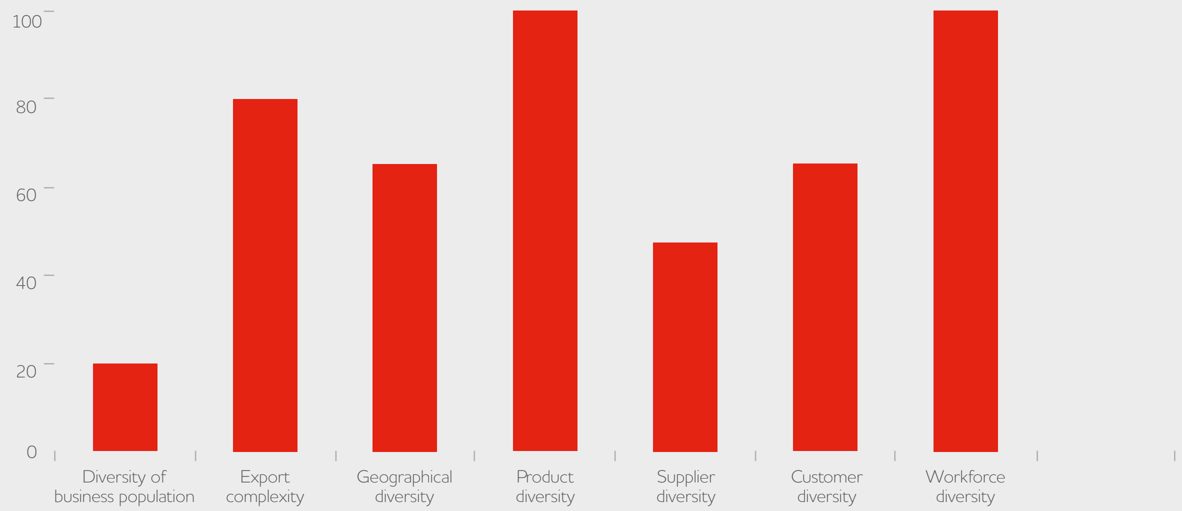
At a city level, the diversity of the business population in Cambridge is lower than average, due to the high share of SMEs operating in professional, technical & scientific activities and a relatively limited presence in manufacturing and construction. Norwich performs better by this measure, due to its well-established agriculture and construction sectors. Turning to the composition of the export basket, export complexity in the East of England is higher than average for the UK, with particular strengths in the production of medicinal & pharmaceutical products and inorganic chemicals. A large source of this comparative advantage comes from the cluster of science and tech firms in and around the Cambridge area, as well as the world leading research university.

The diversity of the workforce among SMEs in the survey was lower in the East of England than in any other part of the UK. In Norwich in particular, businesses on average indicated that 40% of their employees were female and 14% were from Black, Asian or other ethnic minority backgrounds, compared to a sample average of 49% and 18%, respectively.

London

London has the second highest export complexity in the UK, with particular advantages in the production of telecommunications & sound recording equipment, beverages, watches & clocks and travel goods. The capital's strength in the latter category is likely a result of the 18 million international visitors that London has received on average each year over the past five years, providing a vast stream of export revenues. It is worth noting that this measure focuses only on the export of goods. London's status as an international hub for an array of service sector industries, including finance, law and IT, means that its export complexity is even greater than the composition of its goods export basket would suggest.

FIGURE 8: SME COMPLEXITY MEASURES, LONDON (IDBR, HMRC, CENSUSWIDE)



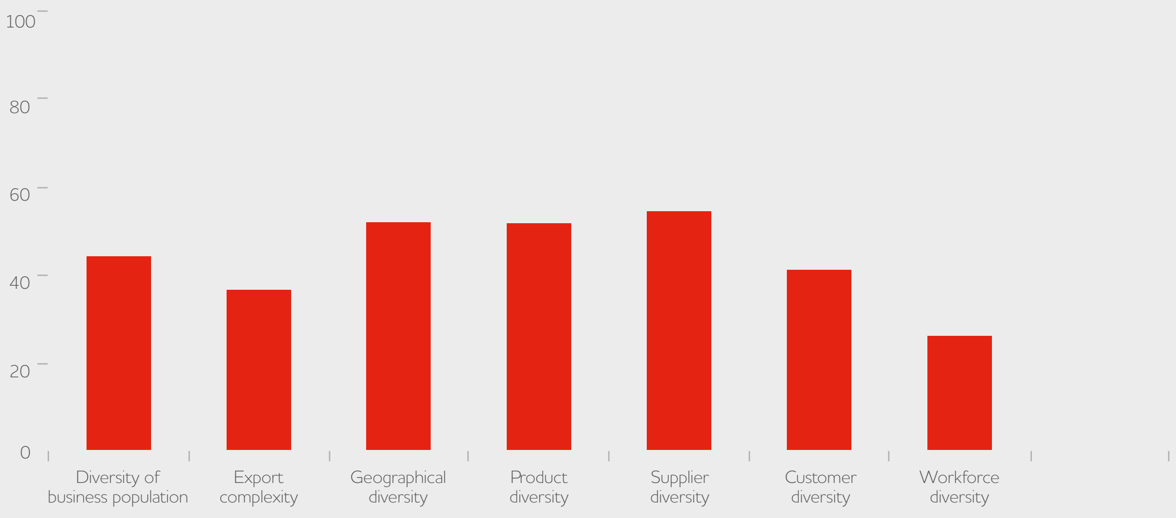
As of the 2011 census less than a half (45%) of London's population was classed as White-British, making the capital by far the most ethnically diverse part of the country. This is reflected in a very high score for the workforce diversity measure for London's SMEs. A metric where SMEs in the region fare less well is supplier diversity: the majority (57%) of firms surveyed stated that they would need more than three weeks to replace their most important supplier or sub-contractor.

While the majority (51%) of SMEs surveyed in London indicated that most of their sales are attributable to either a single product or a small number of closely related products, there is a substantial minority with a more diverse product offering. Indeed, around one in six (16%) stated that most of their business' revenues are attributable to a high number of products that fall into a variety of categories. This, together with the results for the export complexity measure, points to a high level of complexity in London both at an individual business level and a city level and bodes well for the resilience of the London economy – despite the significant worsening of the SME Health Check Index in Q2. Although there has been a growing push to decentralise the economy away from London, the capital's historic position at the heart of the economy has provided it with many ingrained advantages, ranging from its infrastructure to a rich pool of human capital and knowledge that has been enriched by the network effects associated with such a large urban centre.

North East

Across the various measures analysed, diversity both within and across businesses tends to be lower in the North East than elsewhere in the country. Only around one in twenty people in the region come from ethnic minority backgrounds, which inevitably feeds into the score for the workforce diversity measure. However, North East based SMEs in the survey were in line with the sample average when it comes to the share of women in the workplace.

FIGURE 9: SME COMPLEXITY MEASURES, NORTH EAST (IDBR, HMRC, CENSUSWIDE)



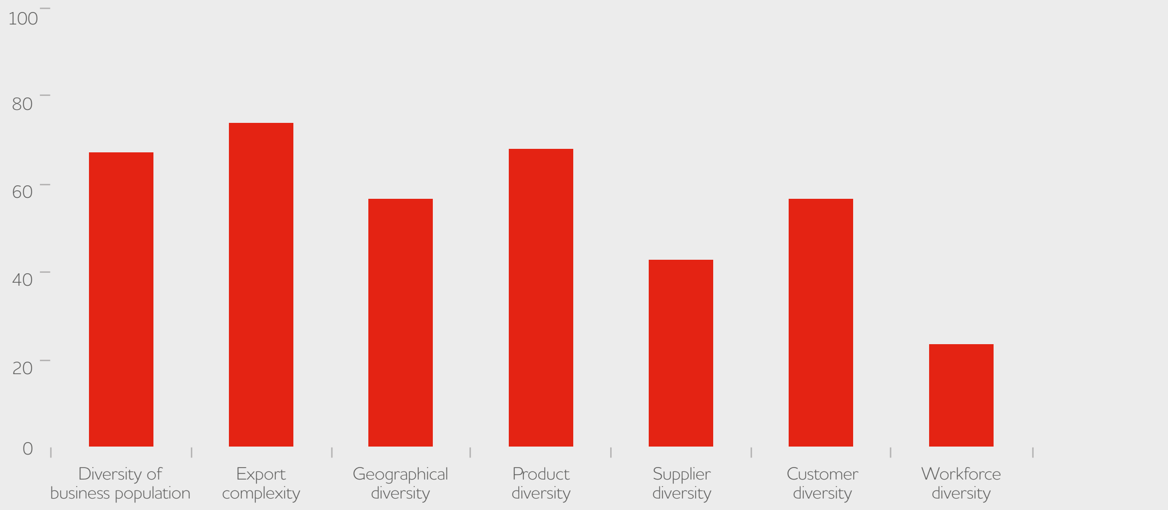
The presence of major international firms in the automotive and construction machinery sector such as Nissan, Caterpillar and Komatsu mean that the North East punches well above its weight in vehicle exports. However, with the exception of transport equipment and also coffee, tea & cocoa products, there are relatively few areas of comparative advantage apparent in the export basket of the North East.

At a city level, Newcastle performs poorly among the geographical and product diversity measures. Among the SMEs in the survey, less than one in ten (9%) operate across multiple regions. This will be due in part to the relative geographic remoteness of the North East, with transport connections to the rest of the country lagging behind those available in other parts of the UK.

North West

The two largest cities in the North West – Manchester and Liverpool – have similar levels of diversity among their business population, with both having a strong spread of businesses across the various parts of the services sector, as well as a presence in the manufacturing and construction sectors.

FIGURE 10: SME COMPLEXITY MEASURES, NORTH WEST (IDBR, HMRC, CENSUSWIDE)



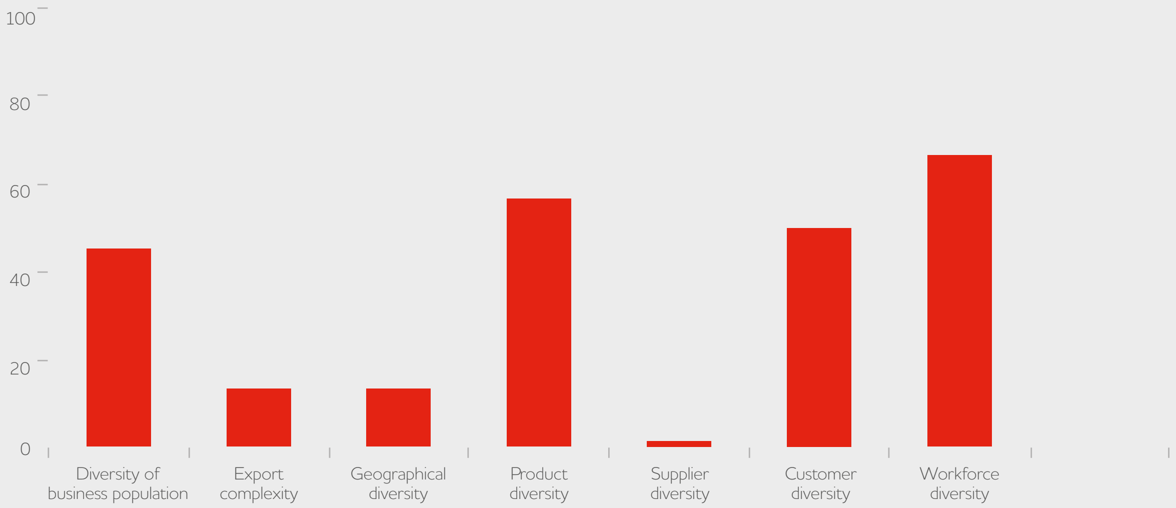
Nearly one in five (19%) of Manchester based SMEs in the survey indicated that they operate across multiple regions. This is higher than anywhere else in the UK, reflecting the city's geographic position in the centre of the country, which makes it more feasible for SMEs to operate in several different regions. The Manchester-based businesses in the survey had on average a more diverse product offering than those in nearby Liverpool. However, SMEs in the survey from Liverpool exhibited more diversity both upstream and downstream in the supply chain, with a lower reliance on a small number of large customers or suppliers.

The North West has the third highest export complexity in the UK, with a revealed comparative advantage in the production of dairy products and chemicals. According to a parliamentary document, in the event of a no-deal Brexit, UK companies would have to transfer their REACH (the EU's regulatory framework for chemicals) registrations to a European company in order to maintain access to the European Economic Area. This outcome would threaten many firms' access to the key European market and is an example of one of the many non-tariff barriers to international trade that could follow a disorderly Brexit.

Scotland

Scottish SMEs perform poorly across many of the diversity measures analysed. The survey results suggest that businesses in Scotland are exposed to potential disruptions in their relationships with key suppliers. This is particularly the case in Glasgow, where SMEs on average indicated that they would need over a month to replace their most important supplier or sub-contractor. Meanwhile, less than 8% of SMEs surveyed in Scotland operate in multiple regions, with this share falling to just 3% among those based in Edinburgh. While the legal and regulatory structures are broadly aligned between Scotland and the rest of the UK, there do exist some divergences which may represent an obstacle to Scottish firms operating in other parts of the country.

FIGURE 11: SME COMPLEXITY MEASURES, SCOTLAND (IDBR, HMRC, CENSUSWIDE)



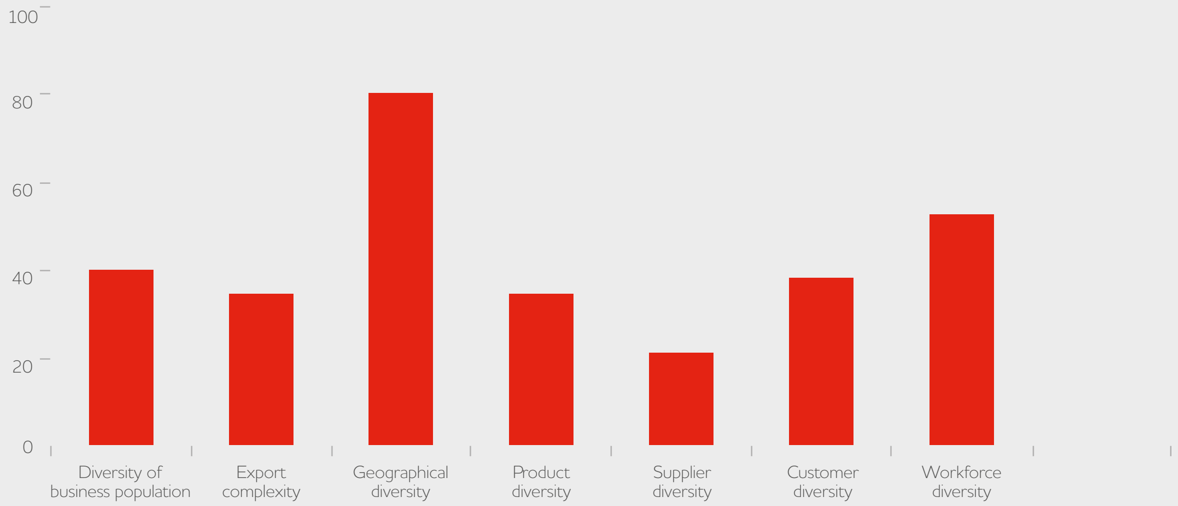
Scotland also has the lowest export complexity score out of the regions covered. The data on goods exports indicate that the primary source of comparative advantage relative to the rest of the UK comes from the extraction of fossil fuels, a consequence of the presence of North Sea oil off the Scottish coast. Other strengths include the production of beverages, as well as the export of live animals. Indeed, Scotland accounted for nearly half (44%) of the UK's fish exports in Q1 2019. While Scotland's rich natural resources allow it to excel in these key sectors, the export data show that considerable scope remains for the nation to carve out further areas of comparative advantage.

Scottish SMEs in the survey achieve higher than average scores for the product and customer diversity indicators, and the level of workforce diversity in Scotland is surpassed only in London and the West Midlands. Across Scotland as a whole, ONS data show that 49% of those in employment are women. However, among the SMEs in the survey, this share rises to 54%. The greater gender balance of the workforce in Scotland reflects both a higher than average employment rate among women of 73%, as well as a lower than average employment rate among men. The large share of women that Scottish SMEs employ appears to have been a key factor facilitating the overall growth in employment in recent years. A continuation of this trend going forwards would bode well for the employment indicator and the wider SME Health Check Index for Scotland.

South East

The South East has a mixed performance across the measures of SME complexity. 15% of SMEs surveyed in the South East operate across multiple regions. The economy of the region is closely integrated with London, with an array of train networks linking the regions and facilitating large commuter flows in both directions. As a result, 14% of SMEs based in the South East carry out at least some of their operations in London, while one in ten (10%) of the SMEs surveyed from London also operate in the South East.

FIGURE 12: SME COMPLEXITY MEASURES, SOUTH EAST (IDBR, HMRC, CENSUSWIDE)



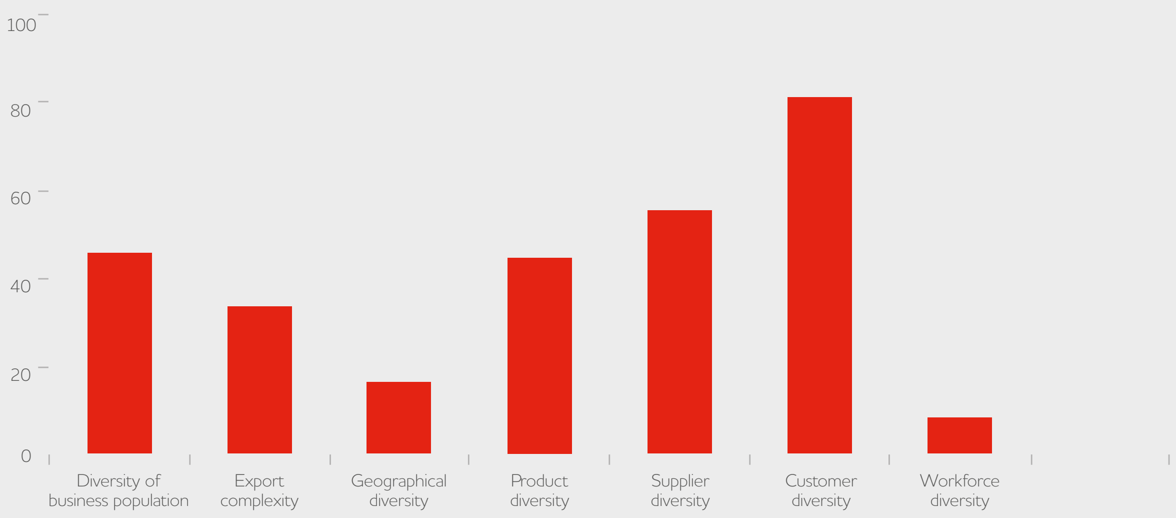
Another strength for SMEs in the region is the level of customer diversity, with only two out of five businesses indicating that over the past 12 months, they relied on their three largest customers for at least half of their revenues. The South East and London are the two most populous regions in the UK, and therefore feature a rich pool of potential customers for SMEs to draw from, allowing the diversification of their client base.

The large number of SMEs in the South East that operate in a relatively narrow selection of professional fields, such as civil engineering, management consultancy, and computer programming, mean that the diversity of the region's business population is among the lowest in the UK. This is particularly true for Reading, where the business population is less diverse than in any of the other 25 cities analysed. According to the IDBR, computer programming and management consultancy account for nearly a third of (31%) of total businesses in Reading, which is the primary driver of the low diversity score. Despite its basket of export goods being relatively low in complexity – as may be expected given the service-oriented nature of the region – the South East does have some pockets of strength, such as in the production of photographic and telecoms equipment.

South West

Only 8% of SMEs surveyed in the South West conduct operations outside of the region, which is a likely symptom of the sheer distance and often limited transport links that separate many parts of the South West from the rest of the country. The South West is the least densely populated part of England, meaning that many SMEs in the country will not have the luxury of a large available customer base that they can target in the proximate area. However, in recent decades, technological growth has eroded many of the barriers traditionally associated with geographical distance. This is evidenced by the results of the survey, which finds that on average, firms in the South West rely on their largest three customers for just over a third of their revenues (35%) – below the sample average of 38%. The results for the geographical diversity measure suggest that SMEs in the South West have fewer extra-regional ties than those situated elsewhere in the country. The uptick in the SME Health Check Index for Q2 – driven by the lending and confidence indicators – indicates that this greater degree of self-reliance may mean that sentiment has not been hit to the same degree in the South West by the uncertainty surrounding Brexit.

FIGURE 13: SME COMPLEXITY MEASURES, SOUTH WEST (IDBR, HMRC, CENSUSWIDE)

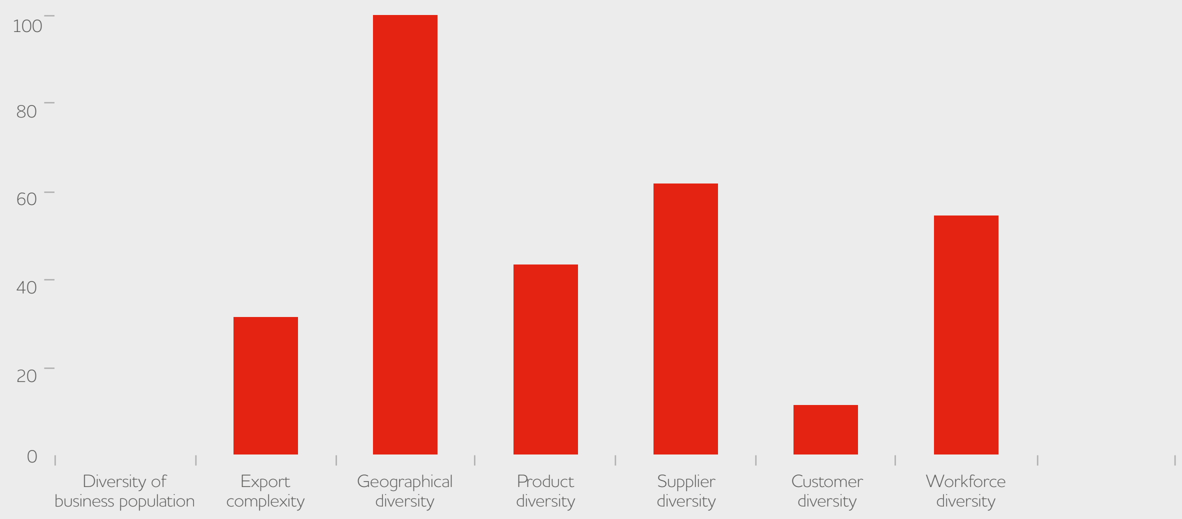


Bristol – the largest city in the region – has a more diverse population of businesses than the region and the UK as a whole. Although the city has a relatively low share of SMEs in the manufacturing sector, this is offset by a strong balance of service sector firms operating across a range of industries such as arts & recreation and transportation & storage, as well as in more ubiquitous fields such as professional services.

Wales

Wales' population of businesses is the least diverse in the UK in terms of the industries in which they operate. Three in ten Welsh SMEs work in one of three sectors: crop and animal production (13%), specialised construction activities (9%), and retail (9%). However, the data points to a significant split between Wales' major cities and the nation as a whole. For instance, Cardiff's business population is the third most diverse out of the 25 UK cities analysed, driven by a lower prominence of firms in the retail and construction sectors and a higher representation in professional activities, including financial services and legal services.

FIGURE 14: SME COMPLEXITY MEASURES, WALES (IDBR, HMRC, CENSUSWIDE)



Nearly one in five (17%) of Welsh SMEs surveyed stated that their business operates in multiple regions. This gives Wales the highest score in the UK along the geographical diversity measure. The survey results show that Welsh SMEs have the closest ties to the neighbouring West Midlands region.

The complexity of Wales' export basket is below the UK average. While Wales' climate and topography provide it with a natural comparative advantage in agricultural fields, such as animal rearing and dairy production, there are relatively limited areas of strength reflected in the data for manufacturing exports.

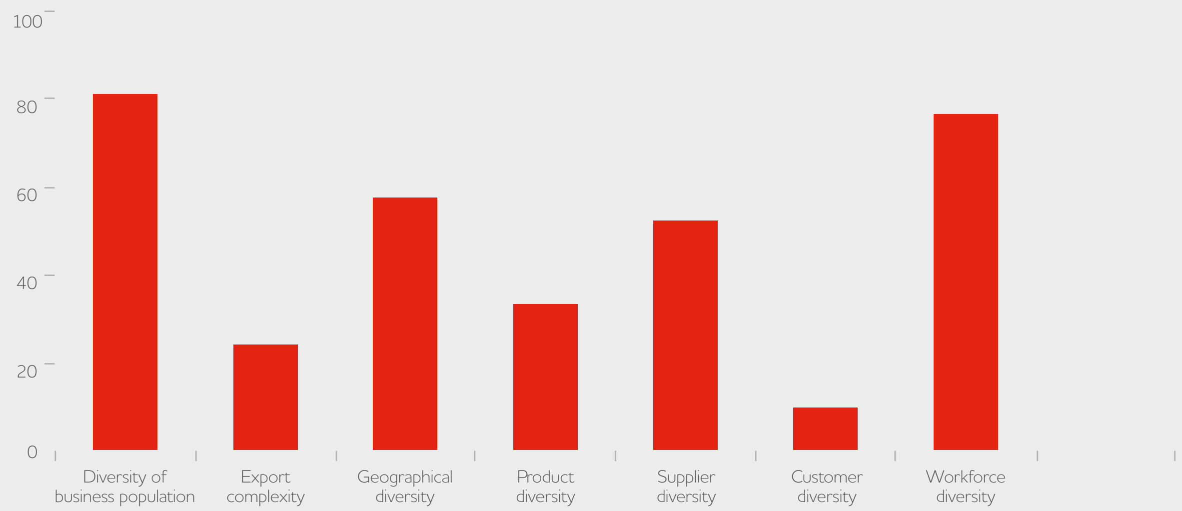
West Midlands

The West Midlands performs well among many of the measures of diversity and complexity. The population of businesses in the region is the most diverse in the UK in terms of the industry mix. This is a result of the West Midlands' substantial manufacturing and agricultural sector, together with a services sector in which firms' operations are well balanced across a range of activities. While the region saw a deterioration in the SME Health Check Index in Q2, the diversity of its SME population makes the region's economy as a whole less exposed to specific negative developments in certain sectors.

Focusing in on Birmingham – the region's largest city – the population of businesses is slightly less diverse than the wider West Midlands region, due to a slightly higher emphasis on the retail sector, which accounts for nearly one in ten SMEs.

SMEs from the West Midlands also recorded very high levels of diversity within their workforces. On average, respondents indicated that one in five (19%) of their staff were from Black, Asian or other ethnic minority backgrounds and more than half (53%) were female. The share of female workers in SMEs rises to 56% among those based in Birmingham – the second highest share out of the cities covered.

FIGURE 15: SME COMPLEXITY MEASURES, WEST MIDLANDS (IDBR, HMRC, CENSUSWIDE)



Perhaps surprisingly given the West Midlands' diverse range of businesses across a number of sectors, the region performs fairly poorly in the measure of export complexity. This is because the region's major exports – such as road vehicles and specialised machinery – are also produced in numerous other UK regions, such as the North East, the North West, and the South East. The ubiquity of these major export products therefore reduces the export complexity score for the West Midlands.

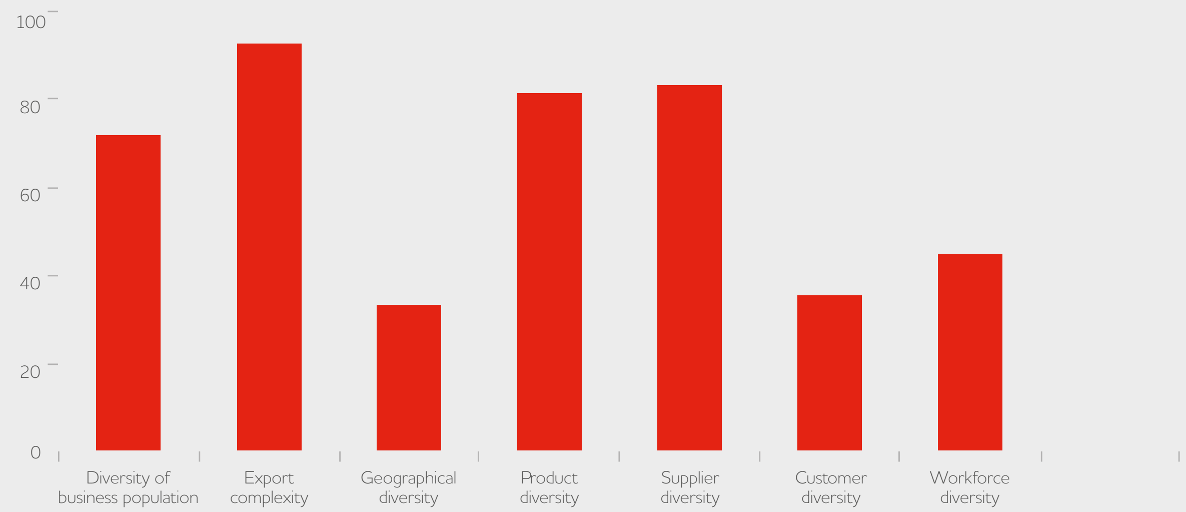
Yorkshire & the Humber

The selection of goods that are exported from the Yorkshire & the Humber region are the most complex in the UK. The region has a revealed comparative advantage in a broad range of agricultural products, as well as in the production of iron and steel, reflecting the region's historical ties to this sector and the presence of British Steel. Yorkshire & the Humber's complex export basket is supported by a highly diverse industrial base, with the measure of the diversity of the business population second only to the West Midlands. Leeds has a more diverse mix of businesses than any of the 25 cities covered, with a range of manufacturing activities taking place within the city. Leeds also has a very balanced services sector, with well-established industries including retail, computer programming, real estate and legal services. The diversity of the economy is a major asset for the region, allowing it to achieve growth in a more sustainable manner with less exposure to sector-specific shocks.

SMEs in this region also exhibit high levels of product complexity, with only around one in eight (13%) of the businesses surveyed indicating that most of their business' sales are attributable to a single product or service. The level of product complexity increases further when focusing solely on Leeds, the region's largest city. Another source of strength for the region is its businesses' supplier diversity. Over the past 12 months, SMEs from Yorkshire & the Humber used on average 14 different suppliers – more than in any other part of the country.

The diversity and complexity that Yorkshire & the Humber's economy exhibits across a range of measures provides some source of encouragement for the region, following the steep fall in the SME Health Check Index in Q2. In particular, the robustness of the supply chains among SMEs in the region will be advantageous in navigating the various obstacles that may present themselves depending on the outcome of the Brexit discussions in the coming weeks and months.

FIGURE 16: SME COMPLEXITY MEASURES, YORKSHIRE & THE HUMBER (IDBR, HMRC, CENSUSWIDE)



Summary of results

Diversity can be highly beneficial to the health of a local economy and business population, by limiting the adverse impacts associated with customer or sector-specific shocks, while also facilitating the operational gains that can result from an increased exposure to a broad range of approaches and skills.

The results of this study into the level of diversity within and across businesses uncovers a highly varied picture in different parts of the UK. In each of the UK's regions, services account for the largest portion of the economy. Therefore, in many instances, the diversity of an area's business base is driven by how balanced activity is across the various distinct parts of the services sector. For instance, Leicester in the East Midlands is ranked as having one of the most diverse business populations in the UK, with service sector SMEs spread across a diverse range of fields from financial services to human health & social work. With that being said, SMEs operating in the agriculture, energy, construction and manufacturing sectors add significantly to the diversity of the business population, as is the case in the West Midlands and Yorkshire & the Humber.

The diversity of the business population in Yorkshire & the Humber is also reflected in its basket of export goods, which is the most complex in the UK. However, a complex export basket requires not only a diverse range of products but also that these products are not commonly exported from elsewhere in the country. In this respect, Yorkshire & the Humber benefits from various pockets of comparative advantage, such as its historical ties to British Steel and its topographical and geotechnical characteristics that have supported agricultural exports. In London – the part of the UK with the second most complex export basket – the presence of a large internal and international market drives a comparative advantage in fields such as travel goods, watches, and clocks.

SMEs in London have higher levels of product complexity and workforce diversity than any other part of the UK. The latter factor is primarily driven by the ethnic composition of the wider population. While the gender breakdown of the workforce among the SMEs surveyed reflects the broader national picture of higher employment rates among men than women, there are some notable exceptions. For instance in Scotland, SMEs reported that on average 54% of the staff were women, with this figure rising to 56% in Birmingham in the West Midlands.

The analysis of the extent to which and where SMEs across the country spread their activities reveals that businesses in Wales and the South East are the most likely to operate in regions outside of their primary location. In the case of Wales, this is due to close economic ties to the neighbouring West Midlands region, while geographical proximity and deep transport links mean that 14% of South East-based SMEs also operate in London.

At a national level, this study confirms that SMEs in the UK operate across a broad and diverse range of industries. There are particularly large populations of businesses in the construction, retail and restaurant sectors, although there is also a strong representation in numerous other industries from agriculture to real estate. The diversity of the SME population is a key asset for the UK economy as a whole which will help it to weather an array of potential sector-specific shocks which could include housing crises, climatological changes or trade frictions.

When it comes to the complexity of the product offering, the survey results show that a majority (60%) of SMEs rely on a single or a small number of closely related products for most of their revenues. While there are benefits associated with specialisation, this level of focus exposes businesses to changing consumer preferences. SMEs on the whole are confident about their ability to replace key suppliers further up the supply chain, on average estimating they would need around three weeks to replace their most important supplier. With that being said, even this period of time would represent a critical loss of revenues for many SMEs, pointing to substantial supply chain risks in many UK businesses.

Given the relatively small geographic scale of the UK, an intriguing result from the survey is that just 12% of SMEs operate across multiple regions. Even in the case of closely integrated regions such as London and the South East, only a small minority of firms conduct their activities across regional boundaries. This shows that despite the technological changes that have taken place in recent years which have eroded the significance of geographical distance, the vast majority of businesses continue to operate at a relatively local level. There are a variety of factors that could drive this, ranging from transport costs to cultural differences between regions. These geographical frictions notwithstanding, the finding implies that many SMEs are not fully tapping into the large pool of potential customers based elsewhere in the country.

5. CONCLUSIONS

Declines across all but one of the indicators brought the SME Health Check Index to an all-time low in the second quarter of 2019. The GDP indicator fell by 19 points between Q1 and Q2 as the UK economy suffered its first quarterly contraction since 2012. Although much of this is attributable to the temporary effect of the winding down of accumulated inventories, falling business investment and exports represent a more worrying trend for the UK's SMEs. The share of SMEs operating below capacity also climbed to the highest level since 2016, which is indicative of a pronounced slowdown in activity in the UK economy. Significant falls in the lending and business confidence indicators signal that many SMEs have grown increasingly wary of the risks to both domestic and global economic outlooks.

The labour market has however remained resilient despite the array of challenges facing the UK economy, and an acceleration in the annual rate of employment growth led to a five-point increase in the employment indicator. While the fact that businesses are continuing to hire despite the cloud of uncertainty hovering over the UK is undoubtedly a positive, high demand for labour has also led to a sharp uptick in employment costs. This was the main driver in the overall increase in business cost inflation in the second quarter of 2019.

The results of the special report on the complexity and diversity of SMEs point to significant variation in the diversity of the industrial base across the UK. The most diverse business populations are found in the West Midlands and Yorkshire & the Humber, which have an established presence in the manufacturing and construction sectors together with a spread of activity throughout the services sector. London leads the way when it comes to product complexity and workforce diversity, with only one in six SMEs in the capital reliant on a single product for most of their revenues. Meanwhile, regions and nations located in the extremities of the UK, such as the South West and Scotland, perform less well along the geographical diversity measure, with the vast majority of SMEs surveyed operating solely within one region.

The SME Health Check Index falls

6.9

points in Q2 2019

16.3

million

total employment in SMEs

6. METHODOLOGY

The SME Health Check Index is designed to measure small business performance and the business and macroeconomic environment within which SMEs operate. The Index includes measures that can be directly linked to SME performance, as well as components that relate to the wider economy. Specifically, the following measures are included:

Business costs
The Index measures the annual change in costs faced by a typical SME and the main data source for this measure is the Office for National Statistics. Higher costs are associated with a deteriorating business environment as companies will either have to pass these on to their clients in order to protect profit margins or accept lower profit margins in order to secure market share.

Capacity
The data for capacity comes from the Federation of Small Businesses (FSB) and measures the proportion of SMEs operating below capacity. If firms operate below capacity, this could have negative implications for hiring and investments intentions. Therefore, a higher proportion of SMEs reporting to operate below capacity will have a negative impact on the overall SME Health Check Index.

Confidence
SME business confidence data also comes from the FSB. The Index indicates how confident businesses are about their short-term prospects over the next three months. Higher business confidence has a positive effect on the SME Health Check Index.

Employment
Data for this sub-component is taken from the ONS and measure the quarterly change in absolute employment figures. Higher employment figures are associated with an improving macroeconomic environment and may signal improved confidence about future workloads.

Gross domestic product
Gross domestic product figures are taken from the ONS and measure the quarterly percentage change in economic growth. For the regional breakdown, we estimated the quarterly figures based on the previous relationships between a region's GVA and overall UK GDP growth.

Lending
For the lending indicator, we used data from UK Finance to calculate the annual change in lending balances. The following measures are included: value of overdrawn balances and value of loan balances.

Net Business Creation
The data comes from the Insolvency Service Statistics and measure the annual growth rate in the number of registered companies. The higher the growth rate in the number of registered companies, the higher the score.

Revenue
Data comes from the FSB and measures the net percentage balance of SMEs reporting an increase in revenues.

Following the data collection, we calculate the average of each individual series (such as employment, GDP etc.). In a second step, we calculate how many standard deviations a single data point (for example the employment data point for Q1 2017) deviates from its long-run mean. We then apply a scoring system ranging from 0 to 100. A score of zero is assigned to the lowest observed value while the highest observation receives a value of 100. This means, the more standard deviations a data point is below the mean, the lower its score and the more standard deviations is above the mean, the higher its score.

This exercise is repeated for each of the eight indicators. The eight individual scores are then combined with an equal weight to the SME Health Check Index. A summary table of the sub-components can be found below:

Sub-component	Source	Measure	Latest score
Business Costs	Various, including Office for National Statistics	Annual change in business costs faced by SMEs	65 (Q2 2019)
Capacity	Federation of Small Businesses	Net balance of SMEs operating below capacity	26 (Q2 2019)
Confidence	Federation of Small Businesses	FSB Small Business – Small Business Index	24 (Q2 2019)
Employment	Office for National Statistics	Annual percentage change in employment numbers	73 (Q2 2019)
GDP	Office for National Statistics	Quarterly percentage change in gross domestic product	53 (Q2 2019)
Lending	UK Finance	Annual percentage change in lending to SMEs	58 (Q1 2019)
Net Business Creation	UK Insolvency Service	Annual growth rate in the number of registered companies	12 (Q2 2019)
Revenue	Federation of Small Businesses	Net balance of SMEs reporting rise in revenue	24 (Q1 2019)

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