paragon

The SME cost squeeze

Small to medium-sized businesses are experiencing increasing inflationary pressures, but are struggling to pass costs onto customers.

Businesses need a razor sharp focus on cashflow

For small-to-medium sized (SME) businesses, resilience has been the keyword for much of the past decade.

Let's just consider the events that SMEs have weathered since 2010. Exiting the credit crunch into an era of Government austerity, through to the Brexit vote and subsequent scruffy implementation. Plus, of course, a once in a century public health crisis and, today, a geopolitical uncertainty not seen since WWII.

But we see SMEs adapt, evolve, invest and - often - thrive. They find solutions to seemingly endless problems, often outside of their control or making.

And businesses are having to find that resilience today more than ever.

The companies that are the lifeblood of the UK economy - the SMEs that create jobs and opportunities and help communities to flourish - are enduring inflationary pressures not seen since the 1970s.

Many are caught between facing increasing fixed and variable costs and not being able to pass those on to their own customers because they are in the middle of a contract that they unable to renegotiate.

This is, of course, creating cashflow issues for many companies.

Our research tells us they are taking action across a number of areas. Some are absorbing these cost increases, others are cutting recruitment, reducing production, slashing research & development and - at least trying to - renegotiate contracts.

One in five have increased their own prices and I would expect more to follow if inflationary pressures continue to worsen. Fortunately, many businesses still have cash at hand as they took advantage of the Government lending schemes during the pandemic, however these reserves are becoming strained.

This report examines some of the pressures companies are under and some of the actions they are taking in response. As a lender, I would urge businesses to talk to their finance provider, to explore options together and to find solutions.

The environment for many is tough, but as history has shown, SMEs find a way. They are resourceful, inventive and, of course, resilient.

John Phillipou
Managing Director
Paragon Bank SME Lending

The cost squeeze

Seven out of 10 SMEs are experiencing cost pressures. We examine how and where they are feeling the pinch.

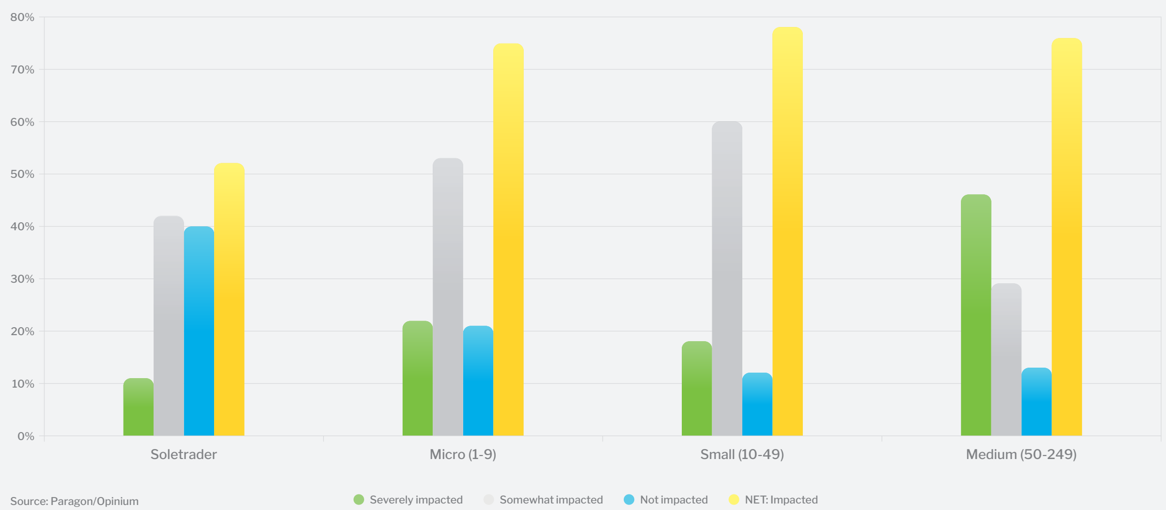
The UK is facing a cost crisis. From consumers to households, we are all feeling the pressure on our finances.

Small-to-medium sized businesses (SMEs) are telling us they are feeling the impact. We commissioned leading research firm Opinium to canvas their views and the results show businesses are under pressure, but are taking action to address the problem.

Over two thirds (69%) of UK SME decision makers say that increasing costs have either severely or somewhat impacted the business they work for. A quarter (24%) of decision makers claimed this impact has been severe.

The impact seems to be harder depending on the size of the company and sole traders have seen less of an impact from these recent cost increases compared to larger businesses. Whilst 52% of sole traders said they had been impacted, 78% of small business decision makers and 76% of medium business decision makers said they had felt the squeeze.

How has your business been impacted by recent cost increases?



Source: Paragon/Opinium

Average cost increases over the last 6 months, by area

16.3% Energy bills	15.1% Company cars / equipment	14.3% Cost of raw materials
14.1% Asset costs	13.0% Postage and deliveries	13.0% Upkeep of premises
12.8% Employee wages / recruitment	12.8% Tax and insurance	12.5% Business rates

Source: Paragon/Opinium

Energy leads the cost increases

Of those who said their business had been impacted, 57% attributed energy bills as a main source of increased costs. Notably, this is being felt more amongst sole traders (62%) than medium-sized business decision makers (49%).

Cost of raw materials (37%), tax and insurance (32%), and postage and deliveries (28%) round off the most highlighted sources of cost hikes amongst SMEs.

Among those that have seen costs increase over the last six months, decision makers picked out energy bills as the area with the biggest cost hikes. SME decision makers claim that, on average, bill costs have gone up 16.3% from six months ago – ahead of any company car/equipment increases (15.1%) or raw material costs (14.3%).

How inflationary pressures are impacting SMEs' bottom lines

SMEs are reporting that the cost issue is impacting their financial performance, with many unable to increase prices

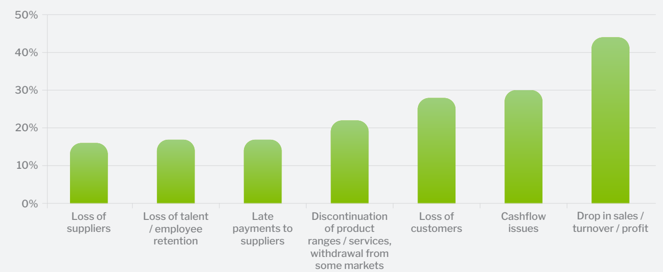
SMEs are feeling the financial impact of inflationary pressures on their business. Nearly half of businesses (44%) have experienced a drop in sales, turnover or profit, whilst 30% said they had experienced cashflow issues. Meanwhile, 28% of companies said they had lost customers.

For larger businesses surveyed, a standout issue has been the discontinuation of product ranges/services or scaling down, as a result of cost increases. A third (33%) of UK medium-business decision makers say this has happened to their business in the last six months, compared to only 7% among sole traders.

Another issue businesses face is supply problems. Over two fifths (43%) of UK SME decision makers say they have experienced supply shortages in the last six months. This is noticeably the case for medium sized businesses (57%), compared to sole traders (21%).

Of those who had seen supplies shortages recently, the main ways these problems were managed was through placing orders earlier and stockpiling (both 42%). Over half (55%) of medium-sized business decision makers say they offered customers an option to wait, cancel or switch to an alternative product.

Impact of cost increases on your business



Source: Paragon/Opinium

Businesses struggle to pass on costs

Over three quarters of medium-sized businesses are absorbing cost increases as they are unable to raise prices for customers.

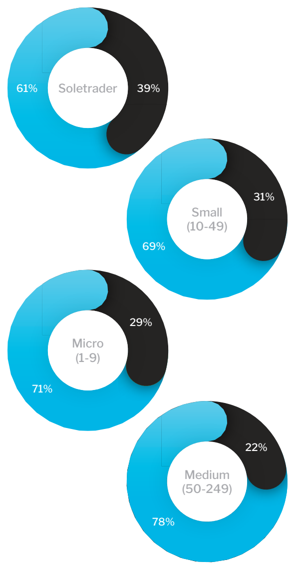
Only a quarter (22%) of medium-sized companies with between 50 and 249 employees have increased prices this year despite soaring costs, rising to just under a third (31%) for smaller businesses with between 10 and 50 employees. Sole traders are more likely to raise prices, with 39% stating their have done so this year.

Over half (54%) of medium-sized firms said they can't raise prices because they are locked into a contract with a customer, with 13% stating they would like to raise prices but are unable to do so as it would make them uncompetitive.

However, businesses said that if costs continued to rise, they would be forced to increase prices. Three fifths (59%) of all SMEs surveyed claimed they would be likely to increase their prices if inflation rises further.

Among those who have increased prices over the last six months, decision makers have on average increased prices by 9.8%. However, it is sole traders that have increased prices more than their larger business peers, increasing the amount they charge by 10.9%, compared to 8.6% for medium-sized companies.

Have you increased prices you charge customers as a result of increased costs?

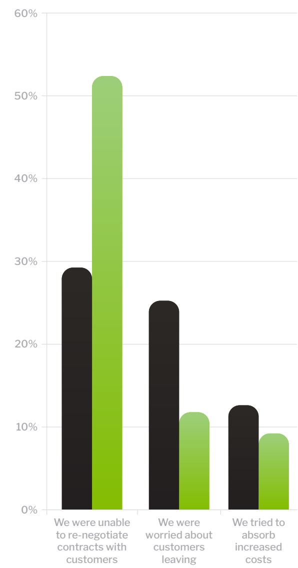


Source: Paragon/Opinium
Yes No

You said you had increased prices. How much has your pricing changed over the last 6 months?

Source: Paragon/Opinium
Yes No

Why small and medium-sized companies have not increased prices



Source: Paragon/Opinium
Small Medium

Mitigating cost pressures

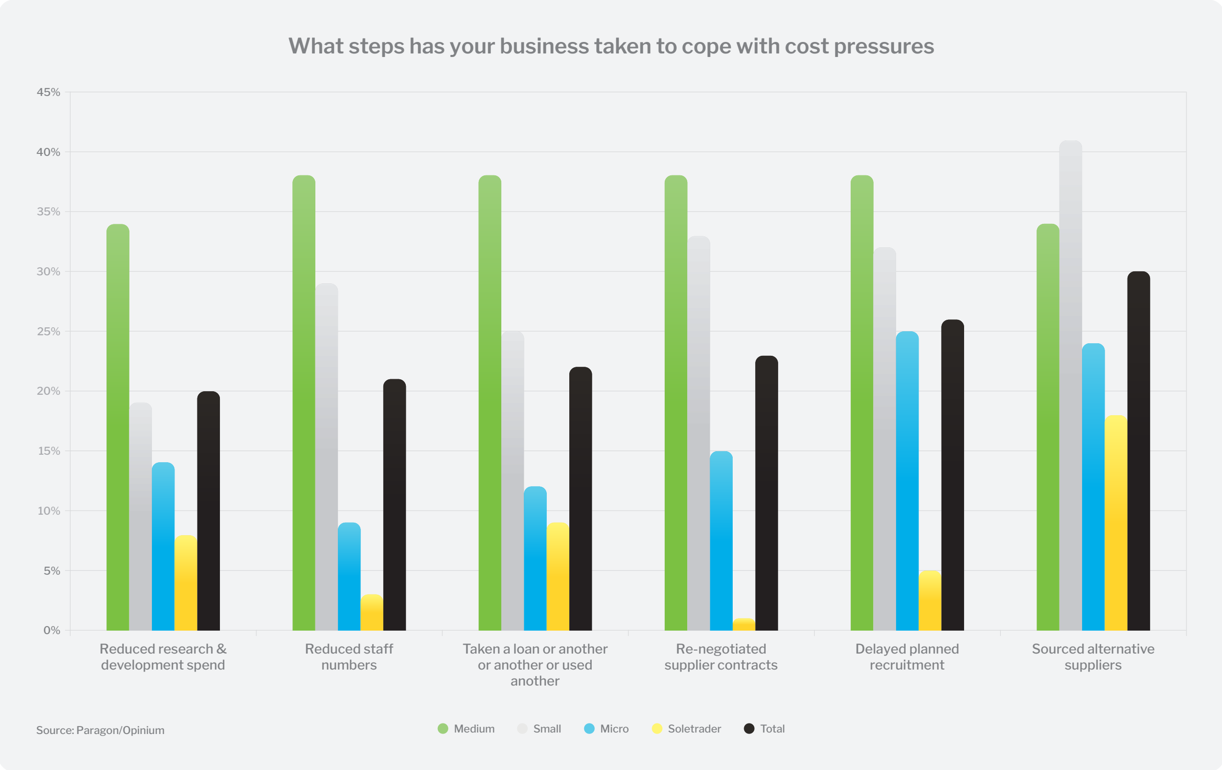
Firms are taking a number of measures to cope with cost increases. We examine some of the steps they are adopting.

The most common action taken by SMEs who have seen their costs increase over the last six months is to source alternative suppliers (30%). This route is particularly popular among small and medium businesses (41% and 34% respectively). Whilst only 8% of medium-sized businesses say they hadn't taken any action to manage increased costs, 61% of sole traders and 34% of small business decision makers said the same.

Many firms were also looking to re-negotiate supplier contracts, particularly those larger SMEs. Overall, 23% of companies were attempting this route, rising to 38% for those that employ more than 50 people.

A quarter of businesses (26%) said they had delayed planned recruitment. Again, this was more common amongst larger companies, with nearly four in 10 (38%) medium-sized companies stating they had delayed recruitment, falling to 32% for those with between 10 and 50 employees.

Other measures cited by businesses included taking out a finance facility (22%), reducing staff numbers (21%) and cutting spend on research and development (20%).



Cash is reality

The adage that cash is reality is particularly apt in today's market. We look at some of the steps firms can use to help cashflow

Cashflow is king

Cashflow forecasting is key to a healthy and successful businesses. We advise clients to prepare a cashflow forecast for a minimum of 12 months ahead to assess where cashflow issues are likely to occur. We also advocate the use of a rolling three-month forecast for more accurate micro-management of cashflow.

One simple technique to use is the receipts and payments cashflow forecast. The top half of the forecast is the cash you think you're getting in, and the bottom half is what you're going to pay out, such as suppliers, tax, payroll, rent. This produces a balance at the bottom. Normally a receipt and payment account is done over a weekly basis, looking forward to the next three months.

Plan, plan and plan again

As the past few months have shown, it can be very difficult to forecast. Who had heard of Covid before November 2019, for example?

Some things you can plan for however, and considering different scenarios should be central to a successful cashflow forecast. Being fully aware of cashflow bumps in the road is the most effective way to mitigate and plan for issues. Ask your business what would happen if a major customer went under or how you would cope with a further increase in variable costs.

Communicate well with customers and suppliers

Open and clear lines of communication are important at the best of times, but certainly when in times of cashflow stress. If all parties are aware of their responsibilities, that can facilitate improved cash management.

For example, having open conversations with suppliers may create opportunities to extend payment terms. Alternatively, if you are a supplier to a larger company, consider calling your contact ahead of issuing an invoice to check it has the right information and to request it is paid in line with the contract terms.

Review contracts

Companies of all sizes are considering what they can do to mitigate cost increases and whether the contracts they are tied to can be renegotiated. This is an opportunity for a thorough audit of contracts and to examine where improvements can be made.

If you are nearing the end of a contract with a supplier, could you consider putting the contract out for tender rather than simply extending, for example.

Refinance assets or extend loan terms

One way to raise finance quickly is to refinance assets. That can either relate to an asset with an existing finance agreement attached to it, or an unencumbered asset. Alternatively, look at extending the term on an existing loan asset. This is a simple measure to take, particularly if you have a good relationship with your lender, and can help reduce monthly payments.

Lease instead of buy

Another way of reducing pressure on cashflow is to lease assets, rather than buy. When you lease an asset, you're renting it for a set period of time. The leasing company retains ownership of the asset while your business has the exclusive use of it for the term of the lease.

Leasing can be more beneficial if the asset needs to be updated on a regular basis, you want to maintain a cash buffer or you don't want to spend cash reserves or go into debt.

Debtor discipline

Invoice discipline and hygiene is central to healthy cashflow management. It is recommended that companies invoice on at least a monthly, or sometimes weekly, basis, where possible. This obviously depends on the type of product or service being offered. A quick tip is for companies to make sure they bill before the month end as this increases the chances of being included in an early pay-run, boosting cashflow.

Consider invoice finance

Invoice finance is an option for companies to release cash from their debtor book. Instead of completing the work and then waiting out the payment terms agreed with your customer, your invoice finance provider will pay you a percentage of the value of those invoices when you raise them. This means you receive at least some of the cash for the work you have completed within as little as 24 hours, boosting working capital and optimising your cash flow.

Overhead discipline

At a time of rising costs – from salaries to energy – it's important that firms maintain overhead discipline. Annual audits of all costs should weed out those overheads that aren't important to the business.

One of the biggest costs for companies is rent and, with the move to hybrid working, firms should consider whether their premises are the right size for the modern workplace. Can costs be saved through more remote working or shared office space, for example?

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