Quantuma

The uneven recovery

In the South West & Wales Region

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The uneven recovery in South West & Wales

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

Looking back over the last couple of years during the pandemic, financial professionals had been anticipating an uptick in restructuring activity from the fall out of both the pandemic and Brexit. It was logical to assume that this would be inevitable with stretched balance sheets from record levels of new debt issued under the various government support schemes, deferred HMRC and rent payments, together with supply chain and labour challenges impacting profitability. However, with the unprecedented level of financial support and protective measures that were put in place by the Government, instead there was a boom in M&A activity and the lowest level of insolvencies on record, with signs of a quick rebound in growth in the later part of 2022.

More recently, the conflict in Ukraine has provided significant additional challenges to the global economy, with the Bank of England recently indicating that a recession in the UK is likely this year. We are now seeing increased distressed advisory and restructuring activity and we have been involved in several businesses that effectively accelerated into the pandemic, with investment or MBOs funded from debt. This growth has not then materialised and whilst lenders have been hugely supportive, the recent additional economic challenges now mean that that these businesses still do not have a clear path to achieving the level of growth and profitability required to meet the significant new debt commitments. As such, it will be very challenging for these businesses to obtain further funding support at a time when we have also seen HMRC starting to tighten their time to pay policy.

We suspect that this may become a common theme following the boom in leveraged MBOs throughout the pandemic, and should the current supply chain, inflationary and labour challenges continue, it could start to drive increased insolvencies before flowing through to those businesses that are solely dealing with the debt caused by the pandemic.

The businesses that we have worked with recently have largely operated in the manufacturing and construction sectors. Based on our Clarity data, these two sectors, together with wholesale/retail, property, technology, financial services and transport appear to be the sectors to watch out for in the South West. In Wales the risk appears to be even more concentrated across construction, property, and transport with construction presenting the main risk. Based on what we have seen recently, highly leveraged businesses in these sectors may be in a good place for lenders and advisers seeking to protect their clients to focus their efforts.

Notwithstanding these challenges, there are always opportunities and for those looking for growth, the South West is leading the way in the UK across wholesale/retail, accommodation/food, agriculture financial services and construction. With some of these sectors also having a significant share of the higher risk businesses, Clarity tells us that this growth should be supported with appropriate risk mitigation strategies.

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Key takeaways

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

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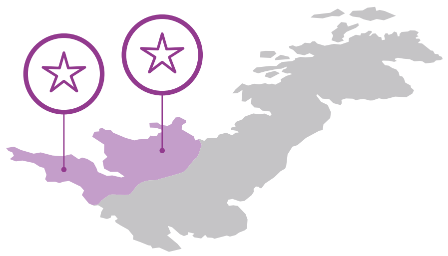
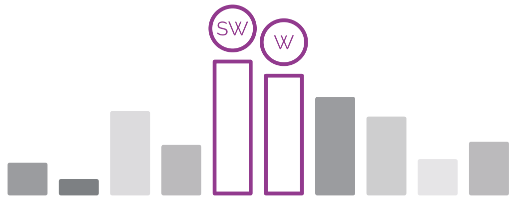
The **South West** and **Wales** region is **leading the pack**



The **South West** and **Wales** region is **leading the pack**, compared with other UK regions, when we look at the **growth prospects** and **financial stability** of SMEs by region.

The **South West** and **Wales** **outperforming London**, and the **UK**



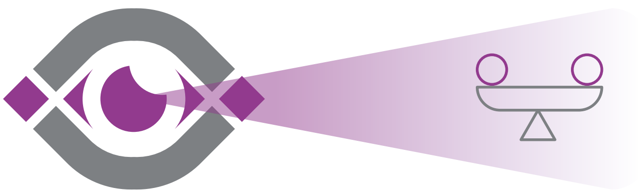
Taking a closer look at what is **driving this growth**, we see that there are several sectors where **South West** and **Wales** are **outperforming London**, and the **UK**, specifically Retail/Wholesale, Construction, and Accommodation/Food.

Retail and **wholesale** are the **key drivers** of **growth**

Whilst the Construction sector is strong in the region, it is the Retail/Wholesale that is the **key driver of growth** due to a combination of factors including the '**staycation**', robust channels of **supply** and **distribution**, and a concentration of independent retailers that benefited from increased tourism in visitor locations.

Region's growth sectors still present risks

The main growth sectors in the South West and Wales also present risks with Construction representing 19% of the higher risk companies in the South West and 36% in Wales, and Retail/Wholesale representing 14% in the South West and 9% in Wales.



Levels of distress in the region have **remained stable**

Levels of distress in the region have **remained broadly stable** in the region, albeit there was a **spike** in **higher risk** businesses in the South West in November and December 2021 and is more concentrated across five main sectors; Construction; Property; Wholesale/Retail; Technology and; Financial Services.

Informed by Clarity

Our new and unique data asset has been developed in partnership with Laeceum (a London-based advisory and consulting boutique serving corporates, financial sponsors, family offices, and entrepreneurs) to support the advisory and lending community in developing predictive insight into the health of the UK's SME community.

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

How Clarity has been developed

Developed by an expert analytics team:

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

More than 30 years of analysis and insight:

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

Powered by leading data assets from Experian:

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

How Clarity will benefit you and your clients

Forward looking to spot opportunities:

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

Working with existing clients:

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

Developing your offering:

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

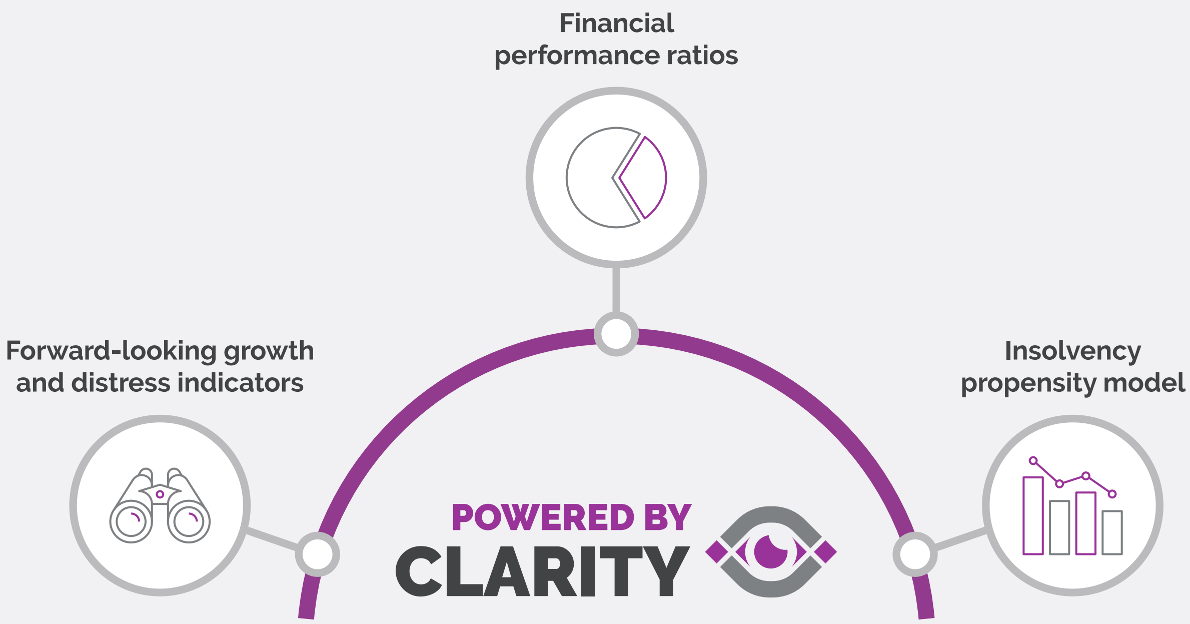
Developing your knowledge:

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

How Clarity works

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

Specifically, the model comprises three components:



Forward-looking growth and distress indicators

The first component of Clarity is a series of **forward-looking distress and growth indicators**. Their predictive nature and analytical basis helps to offset the latency effects of relying on financial information alone (which at times can be as old as 12 months at the point of application). It combines credit information with invoice settlement delinquency and County Court Judgements, producing a score that helps identify businesses that are in distress and potentially at risk of failing within the short to medium term.

Financial performance ratios:

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

Insolvency propensity model:

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

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

Find out more about Clarity:

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

South West and Wales: a growth engine for the UK

In our first uneven recovery report for the UK – published last month – Clarity revealed that SMEs in the South West and Wales regions have improved growth prospects and strong financial stability compared to the UK.

As seen in the chart below when we combine Clarity's Growth Score (GS) and Financial Strength Score (FSS), the South West is 11% higher than that of London. Clarity also reveals that the region presents no additional signs of distress compared with the UK.

The implications of this are significant for the adviser community but also from a policy standpoint. If we are looking to empower SMEs to grow, we believe that much more attention and focus needs to be placed on the South West and Wales.

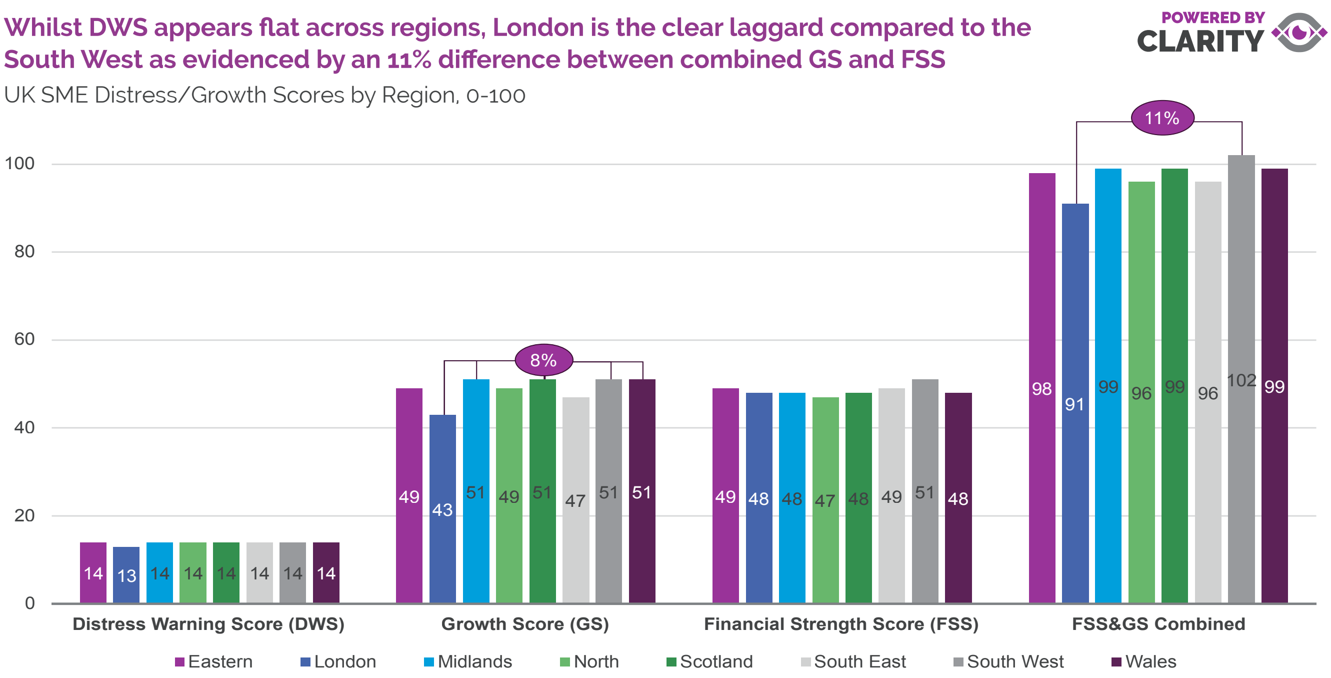
Benefiting from less competition and highly skilled talent

Unlike more densely populated regions, businesses in the South West and Wales have a dual benefit both in terms of access to a highly qualified and skilled pool of talent, combined with a lower intensity of competition and rivalry. Consequently, our findings are in line with our expectations and only serve to reinforce the widely held belief of the importance of the South West and Wales regions.

Given that the South West and Wales regions appear to be home to SMEs that are more likely than the average UK SMEs to be growth champions with more robust financial standing, we believe that there is a call to action for advisers and policymakers to help these SMEs reach the next level through ambitious and accelerated growth strategies.

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

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



Source: Quantuma Clarity

What is driving growth in the region?

When we take a closer look at what is driving this growth, we see that there are several sectors in the South West and Wales where there is significant outperformance compared with London, and the UK.

For several of these sectors, the results are surprising and perhaps counter intuitive to what we might expect. Particularly for Retail/Wholesale[1], Construction[2] and Accommodation/Food[3] sectors where Clarity's Growth Score shows that the South West region is outperforming London by as much as 44%, 21%, and 20% respectively. In some other sectors such as Mining and Agriculture/Foresty/Fishing there is a significant gap, but this is perhaps not all too remarkable given the concentration of those types of businesses in the South West and Wales region relative to the capital and other parts of the UK.

Has the pandemic had a permanent impact on the region?

The reasons behind this disparity can be explained – to an extent – by the impact of the pandemic, with trends like the 'staycation' continuing and helping to drive businesses back to normal trading levels. Indeed, the South West's Growth Value Added (GVA) is expected to grow by 6.1% this year, in comparison to London which is expected to be 4.7%[4].

The rise of working from home has also led to a significant number of people relocating to the region from areas in the South East and London and this is undoubtedly fueling rising house prices across the South West particularly. According to Rightmove's Asking Price Index, the South West is ahead of London in asking price growth with the average marketed value rising by as much as 11.6%. Trends in relocation and a strong return to tourism in the region are most likely driving the region's growth and it looks like this isn't set to change anytime soon.

Retail: a key driver for regional growth

Looking more closely at some of those key sectors that are driving growth, Retail/Wholesale, Construction, and Accommodation/Food are the clear standout industries. Construction in the South West is benefiting from a residential property development boom and development lenders are noticing strong demand and pushing the region due the perceived stability. Whether this is driven by movement out of London, retirees or another factor is uncertain at this stage

The main growth sectors in the South West and Wales also present risks with Construction representing 19% of the higher risk companies in the South West and 36% in Wales, and Retail/Wholesale representing 14% in the South West and 9% in Wales.

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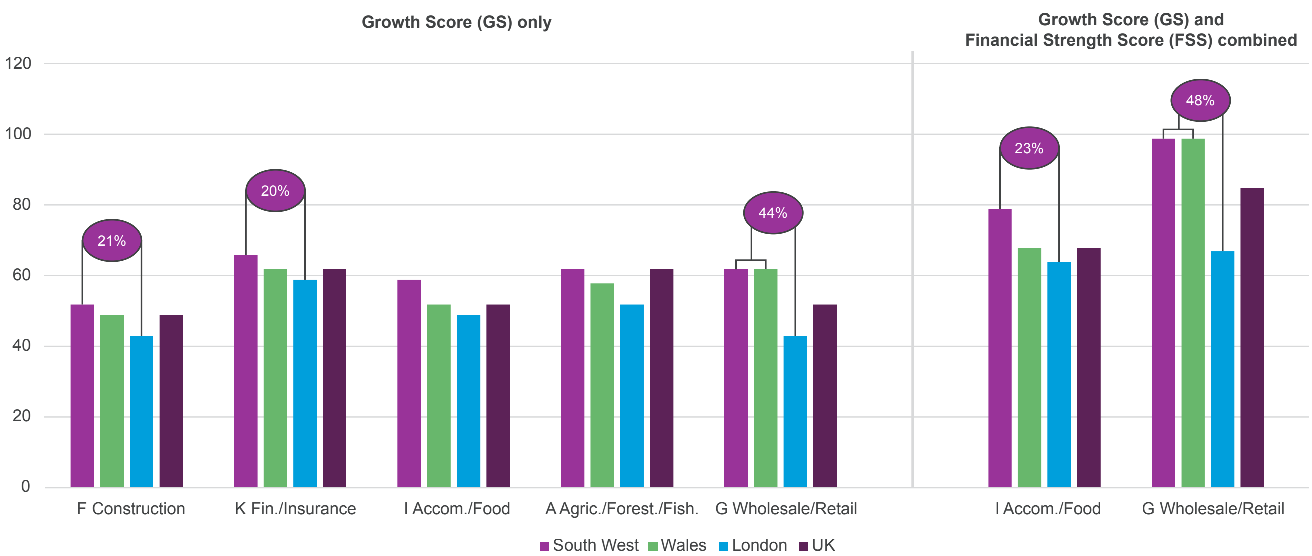

Source: Quantuma Clarity

[1] Includes wholesale and retail trade of vehicles, raw materials, food, beverage, tobacco, household goods, live animals, machinery, fuels, building materials information and communications
[2] Construction of commercial buildings, domestic buildings, roads, motorways, civil engineering projects, etc
[3] Includes hotels, short-stay accommodation, camping grounds
[4] Demos-PwC Good Growth for Cities Index

It is Retail/Wholesale though that appears to have had the greatest impact on growth for the region and particularly in the South West: the difference in Clarity's Growth Score between the South West and Wales and London is significant (44%), and even more so when we combine Clarity's Growth Score with the Financial Stability Score (48%). We believe there are several factors at play here:

- The boom in 'staycations' supported the South West in coming out of lockdowns – in economic terms – faster than anywhere else in the UK, greatly assisting retailers in moving back quicker into near normal trading patterns. Proximity to London and the Home Counties also drove ease of access to fast vacations and there was a link in consumerism due to the inflated prices that are persisting today in the South West vacation hotels and rental properties.
- There is a concentration of independent retailers in the South West, particularly with the 'surf and beach' retailers that have an accumulation of stores in popular beach towns and cities alike. The dual effect of Brexit and Covid really provided a degree of protection by way of retained tourism for these retailers, particularly when restrictions were enforced in London leading to an overnight flight to 'get out'. And as restrictions eased initially in London, a continuation of tourism was felt again in the South West and Wales.

SMEs in the South West are materially more commercially viable

South West SMEs have a materially elevated Commercial Delphi, a measure used to indicate commercial viability from several different factors.

The higher Commercial Delphi for the South West region also reconciles with the Financial Strength Score (FSS) and reaffirms our finding that non distressed SMEs in the South West appear on balance to be slightly healthier in financial terms than their peers across the UK.

Wales SMEs appear more highly levered and efficient than UK and South West SMEs whereas South West SMEs have a significantly elevated Commercial Delphi

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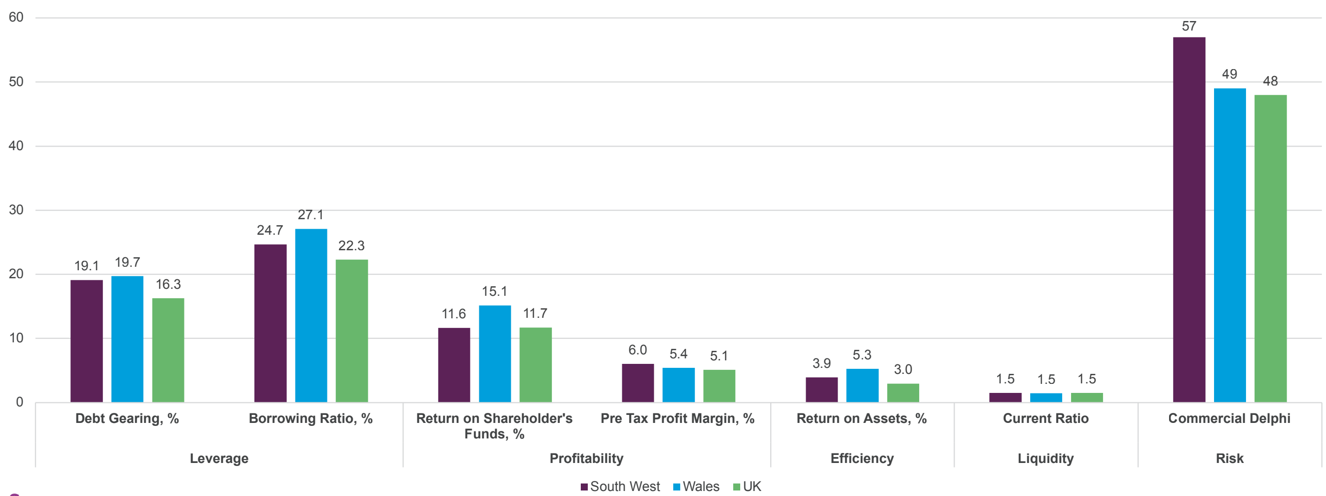


Source: Quantuma Clarity

> *"There are several sectors where South West and Wales are outperforming London, and the UK, specifically Retail/ Wholesale, Construction, and Accommodation/Food."*

Distress in the region

In our first uneven recovery report for the UK, we revealed that distress across the UK regions is broadly consistent. When we couple this insight with the observation that the South West and Wales has a stronger Growth Score (GS) than most other UK regions, we see this as a further positive sign for the future of the region's business community.

Insolvency propensity model

In this section of the report, we use data taken from our insolvency propensity model which allows us to early identify three challenged segments of the UK SME population with a focus on mid-market firms with total assets between £0.5-40m. Each of these segments is categorised according to their insolvency risk, which ranges from 4-25 times greater than the 1% observed average insolvency rate for all mid-market SMEs in the UK, including:

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

Evolution of distress in the region

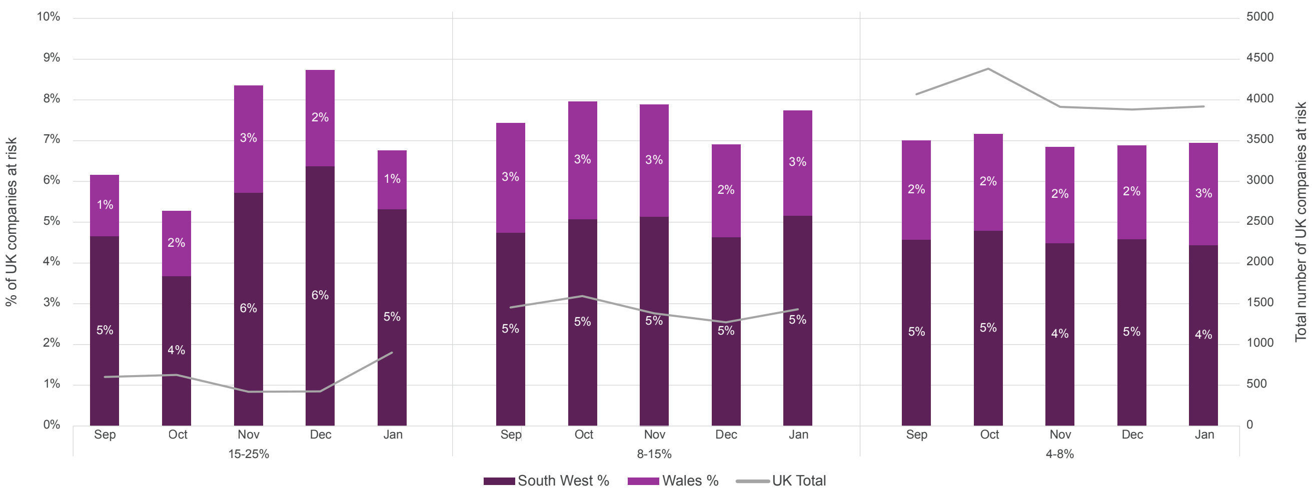
The South West witnessed a spike between December 2021 and January 2022 in the most severely distressed category of SMEs where the risk of failure is between 15-25 times greater than the average UK SME.

When looking at the evolution of distress from September 2021 to January 2022, Clarity reveals that the overall level of distressed SMEs (those between a 4% and 25% greater risk of failure) in the South West and Wales has remained broadly stable within the five-month period. However, in November and December 2022, the proportion of distressed SMEs at higher risk increased in the South West. We do not yet know the causes of this spike, but we will watch this closely going forward to identify any emerging insights.

We will revisit this in our update reports due out in September to take a closer look at what is driving this.

Evolution of distress from Sept-21 to Jan-22:

The overall level of South West and Wales distressed SMEs has remained broadly stable within the five-month period, albeit there was a spike in the proportion of higher risk businesses in the South West in November and December 2021.



Source: Quantuma Clarity

With a less diverse range of businesses than the rest of the UK in the South West and particularly Wales, the higher risk SMEs are more concentrated across fewer sectors. The construction sector presents the biggest risk in the South West and Wales, which is not surprising given that they generally operate with thin margins and are therefore susceptible to cost increases, labour and materials shortages. There have been some significant failures of construction businesses in the region in recent months which were identified by Clarity before they arose, indicating the value of the data.

One thing that the data shows that is perhaps slightly surprising, is that there are a higher proportion of manufacturing businesses at risk in the South West when compared to the UK and Wales. This is because the South West has a lower concentration of manufacturing businesses compared to other parts of the UK, which suggests that there may be a specific additional factor impacting manufacturing businesses in the South West. Most businesses that we have worked with recently have been in manufacturing and the availability of labour has been a significant issue. This could indicate that the availability of labour could be a bigger challenge in the South West, with the increase in people moving to the region largely being in financial and professional services.

Higher risk SMEs in South West and Wales are more concentrated across fewer sectors:

In South West 74% of companies in the highest risk category are across five sectors and in Wales, are concentrated across three sectors.

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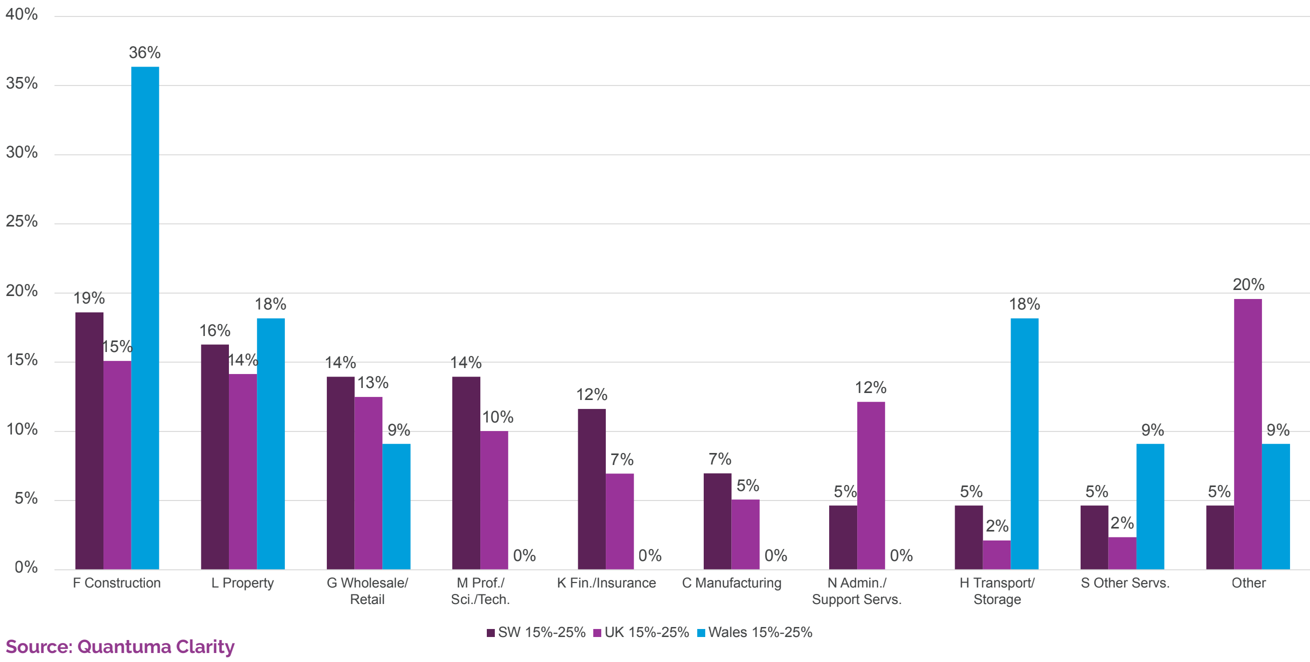

Source: Quantuma Clarity

What comes next?

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

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

To get a copy of this report simply register on our website here: **visit www.quantuma.com/signup**

"Businesses still do not have a clear path to achieving the level of growth and profitability required to meet the significant new debt commitments."

How to get in touch

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

Find out more about Clarity

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

Read more insight on 'The uneven recovery'

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

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Acknowledgements

LAECEUM
STRATEGY | ADVISORY | DATA | ANALYTICS

Clarity has been created in partnership with Laeceum, a London-based advisory and consulting boutique specialising in strategic R&A, SME data and analytics, corporate strategy, and corporate development and advisory. The Laeceum team comprises Founder Ravi Chauhan, Senior Adviser John Mould, Analyst Oliver Benson, and Economist Anjalika Bardalai. You can find out more about Laeceum here: **www.laeceum.com**

Glossary of Terms/Definitions

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

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