COMMERCIAL BANKING

Business in Britain

A survey of opinions and trends
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For your next step

LLOYDS BANK

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INTRODUCTION

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Welcome to the latest half-yearly Lloyds Bank Business in Britain survey, which has been offering insights on the recent performance and expectations of domestic businesses, especially small and medium-sized companies, for over two decades. Our survey is based on the responses of 1,500 firms, drawn from all industries and all parts of the country.

Clearly, the big event of the year so far has been the Referendum in June, in which the British people voted to leave the EU. While exit negotiations have not yet formally started, the vote has introduced some uncertainty for companies. The key message from the latest survey is that business confidence has declined since the start of the year.

It seems clear from the survey that economic growth is likely to slow, following a relatively robust performance before the vote. All of the key metrics in our survey, including the outlook for demand, employment and investment, have weakened. This was the case in all sectors and in the majority of regions.

Nevertheless, it is important to put this into context. While sentiment has fallen to a four-year low, it remains well above the lows reached during the global financial crisis of 2008/9, and the banking sector today is in a significantly stronger Capital position than in 2009.

We look forward to supporting you and your strategic plans and wish you every success in the remainder of 2016 and beyond.

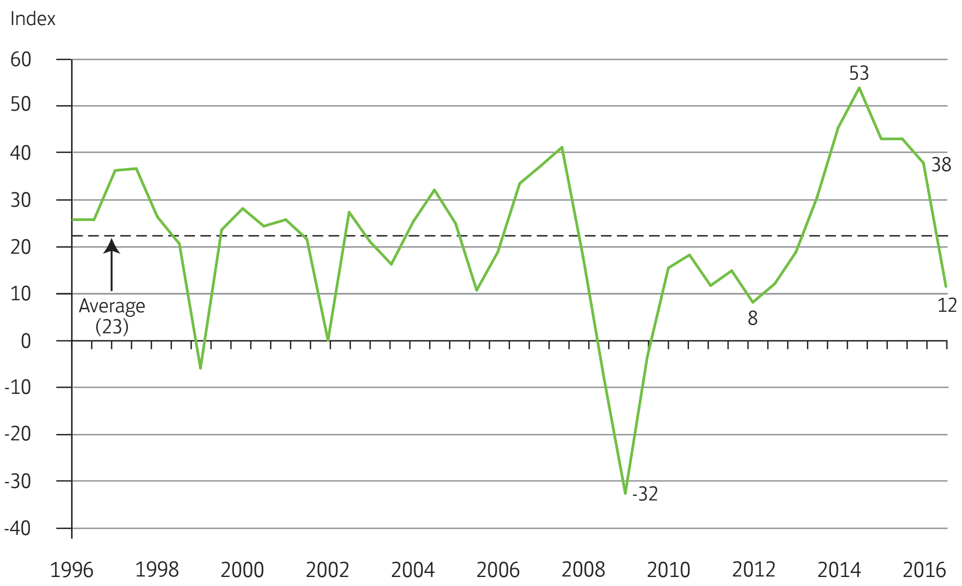
EXECUTIVE SUMMARY

- Business confidence – a metric based on firms' outlook for their sales, orders and profits in the next six months – fell to 12%, the lowest level for four years. The fall takes it back to during the height of the European sovereign debt crisis, but it remains well above the low reached during the 2008/9 global financial crisis.
- The latest survey results signal the potential for a slowdown, but not necessarily a sharp contraction, in economic growth.
- The survey was conducted in the middle of July, ahead of the Bank of England's announcement of policy stimulus, although a reduction in interest rates was anticipated by the majority of survey respondents.
- Export prospects have weakened, particularly with Europe and Asia. The majority of companies indicated that the pound's current value against the US dollar is favourable, while views on the euro exchange rate were evenly balanced.
- Prospects for hiring and capital spending have cooled. The fall to marginal negative territory in the net balance of firms expecting to increase their staff numbers could signal a slowdown in employment growth, while increased economic uncertainty is expected to weigh on investment.
- The proportion of firms reporting difficulties in recruiting skilled labour has fallen to a two-year low of 38%, consistent with a decline in the share expecting average pay to rise in the coming six months. The outlook for profits and general prices has also eased.
- The fall in business confidence was replicated across all sectors, particularly in the service sectors such as retail & wholesale, hospitality & leisure and business & other services. Sentiment also fell in manufacturing, despite sterling's depreciation, which may reflect general sluggishness in domestic and global demand conditions.
- The regional picture was varied and may have been affected by the outcome of the EU referendum. Confidence levels were lowest in London and Scotland, which voted for 'Remain'. Sentiment levels were highest in Wales and Yorkshire.

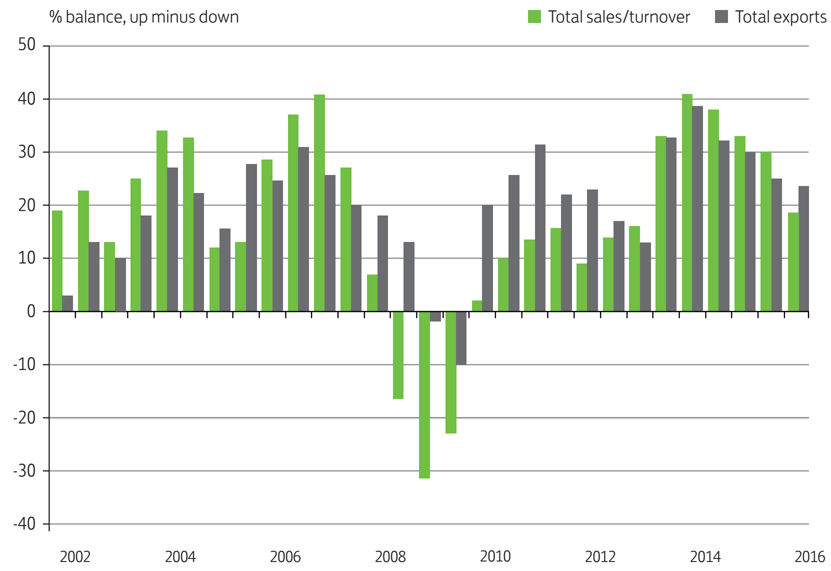
RECENT TRENDS IN THE SME MARKET

BUSINESS CONFIDENCE FALLS TO A FOUR-YEAR LOW

BUSINESS CONFIDENCE



TOTAL SALES AND EXPORTS OVER THE LAST SIX MONTHS



There were already signs of a modest slowdown in anticipated economic activity in the last survey, but the latest results taken after the EU referendum result show a steeper fall in overall business confidence to **12%**. This is the lowest since the mid-2012 survey during the euro debt crisis, although it is well above the depths reached during the 2008/9 global financial crisis.

12%

Overall business confidence – based on the average of net balances of firms expecting higher sales, orders and profits in the next six months fell from 38% to **12%**.

1. The net balance of firms reporting a rise in total sales/turnover in the last six months fell for a fourth consecutive survey, to **19%**, having peaked two years ago. The latest result suggests that sales were at their lowest level since mid-2013, but were not as weak as during the global financial crisis of 2008/9. Forty-two percent (down from 48%) of companies reported higher sales, while 23% (up from 18%) reported lower sales.

19%

The net balance of firms reporting higher total sales/turnover in the last six months fell from 30% to **19%**.

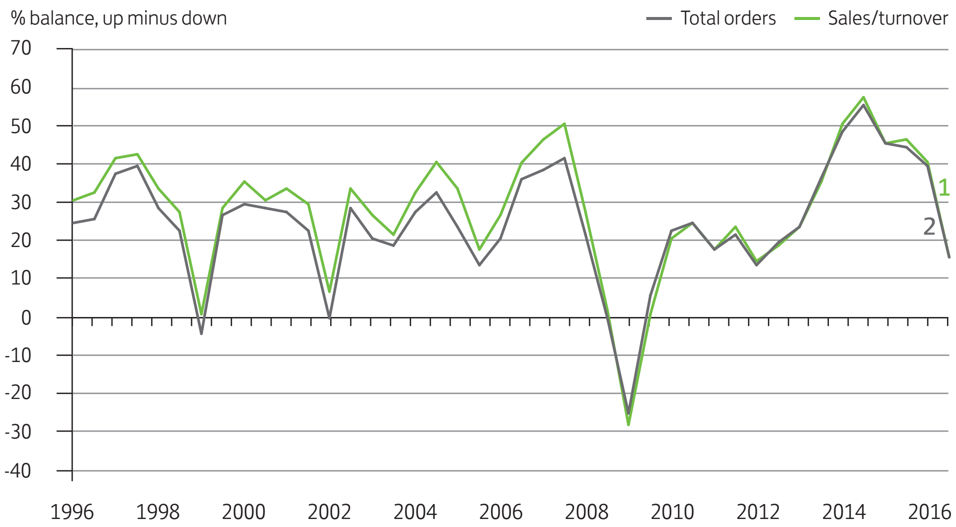
2. The net balance of firms indicating that total exports rose in the last six months also fell for a fourth straight survey, but by only 2 points to **24%**. Although global demand was sluggish, exports may have been supported by the weakening of the pound which had been in train even before the EU referendum. Forty-one percent (down from 43%) of firms indicated that exports had increased, while 17% (unchanged) said that they had fallen.

24%

The net balance indicating that total exports rose in the last six months edged down from 26% to **24%**.

KEY ECONOMIC INDICATORS FOR THE COMING SIX MONTHS WEAKEN

TOTAL SALES AND ORDERS IN THE NEXT SIX MONTHS



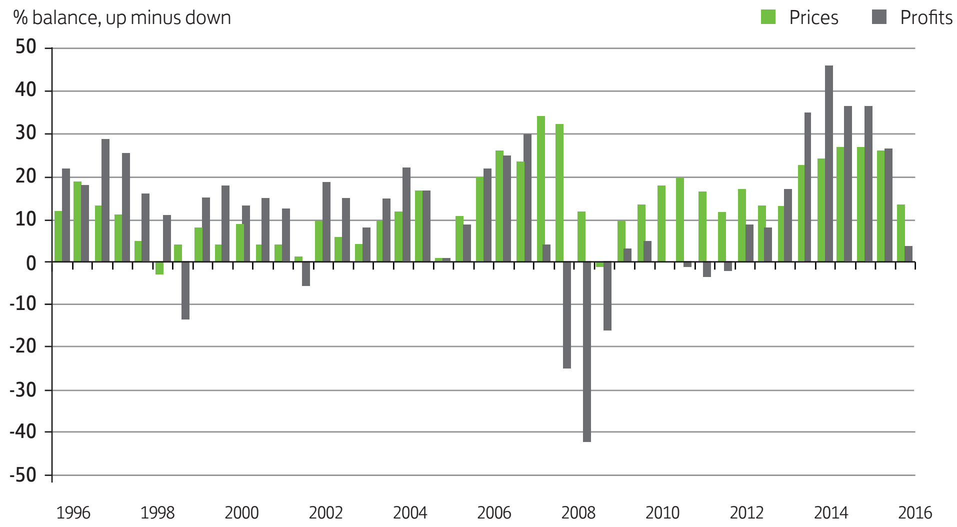
1. Reflecting heightened uncertainty in the aftermath of the EU referendum, the net balance of companies expecting higher sales in the coming six months fell to a four-year low of **16%**. This is a sizeable drop from 41% in the previous survey. Thirty-nine percent (down from 53%) of companies still expect sales to rise, while 23% (up from 12%) predict lower sales.

2. The net balance anticipating higher incoming new orders in the next six months also fell sharply to a four-year low of **16%**. Thirty-seven percent (down from 50%) of firms said that they foresee stronger demand, while 21% (up from 10%) expected orders to weaken.

16% The net balance of companies expecting higher sales in the next six months fell from 41% to **16%**.

16% The net balance anticipating higher total incoming new orders in the next six months fell from 40% to **16%**.

PRICES AND PROFITS IN THE NEXT SIX MONTHS



1. Pricing pressures are expected to ease over the coming six months, suggesting that any boost to import prices from the weaker pound will be offset elsewhere. The net balance of firms expecting to increase their prices fell to **13%**, with 27% (down from 30%) of firms expecting to raise prices and 14% (up from 9%) looking to reduce them.

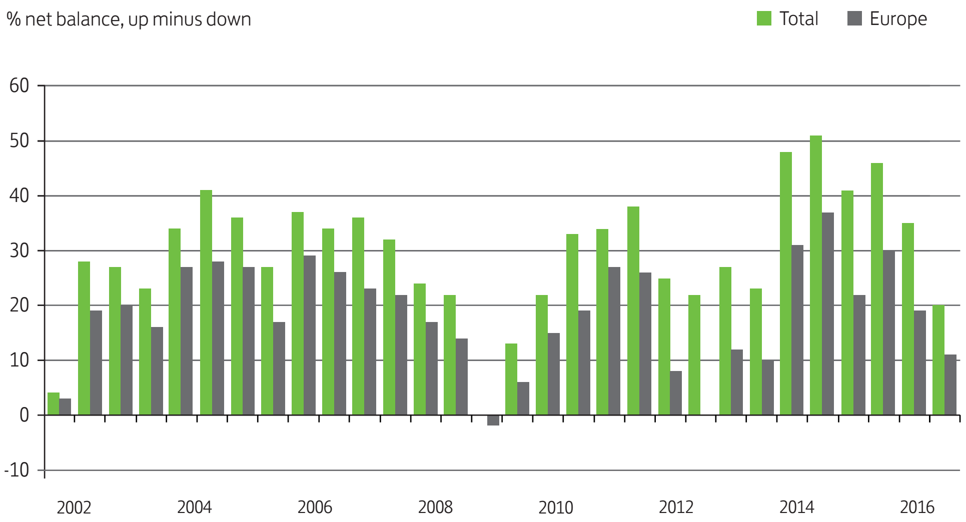
2. A larger share of firms anticipate that their profits will be reduced over the next six months, with the net balance foreseeing higher profits falling sharply to a four-year low of **4%**. Thirty-two percent (down from 46%) of companies believe their profits will improve, while 28% (up from 14%) are bracing for lower profits.

13% The net balance of firms expecting to increase their prices in the next six months fell from 21% to **13%**.

4% The net balance foreseeing higher profits in the next six months dropped from 32% to **4%**.

EXPORT ACTIVITY EXPECTED TO SOFTEN DESPITE THE WEAKER POUND

EXPORT SALES IN THE NEXT SIX MONTHS

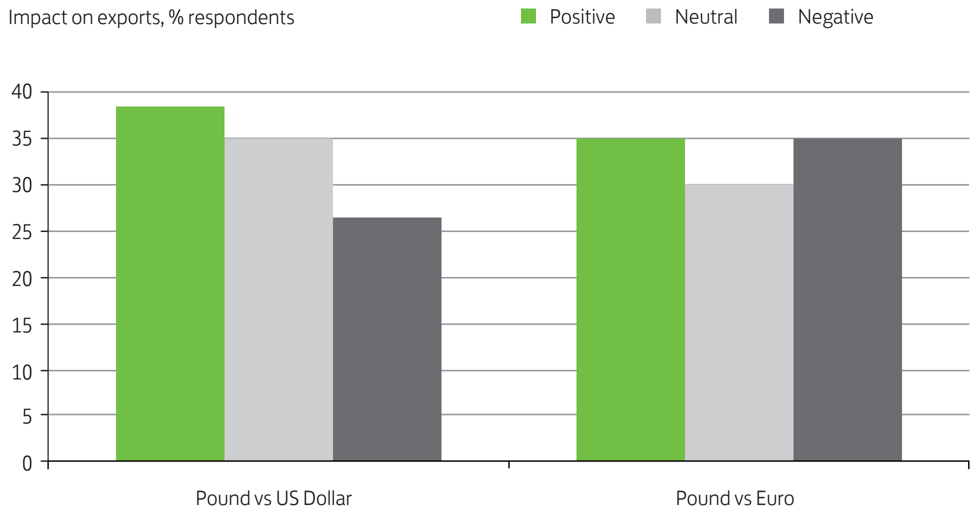


1. Sluggish overseas growth and uncertainties regarding the global outlook have resulted in a further easing of export prospects, with the net balance of companies predicting higher total exports falling to **20%**. Forty-one percent (down from 47%) of exporters anticipate higher sales abroad, while 21% (up from 12%) expect weaker external markets.
2. Export sales to Europe are expected to soften in the coming six months, with the net balance expecting higher exports falling to **11%**. Thirty-five percent of firms (down from 37%) predict stronger sales to Europe, while 24% (up from 18%) predict lower sales. There were also falls in the net balances for exports to Asia and, to a smaller extent, North America.

20% The net balance of companies predicting higher total exports in the next six months fell from 35% to **20%**.

11% The net balance expecting higher exports to Europe in the next six months fell from 19% to **11%**.

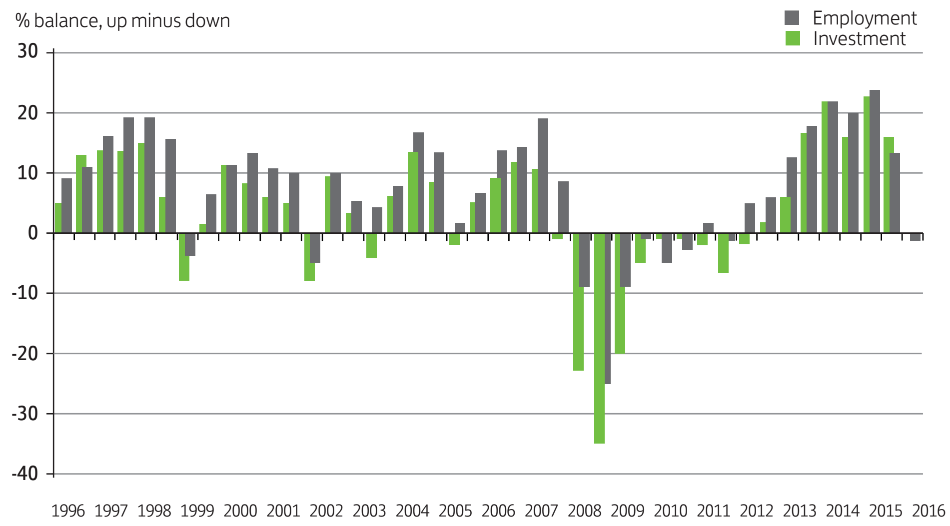
IMPACT OF CURRENT VALUE OF THE POUND ON EXPORTS



1. US dollar: The pound has fallen by more than 10% in trade-weighted terms since the EU referendum, with the decline slightly larger against the US dollar than the euro. As a result, **38%** (up from 23%) of companies now view the current value of sterling against the dollar as favourable for their exports, while **27%** (also up, but to a smaller degree from 21%) still view it as still being too high.
2. Euro: There has also been a rise in the share of firms indicating that the current value of the pound against the euro has become more favourable for their exports. Overall, **35%** of firms (up from 25%) view the current exchange rate as favourable, while **35%** (up from 34%) also view it as unfavourable.

HIRING AND INVESTMENT OUTLOOK DETERIORATES

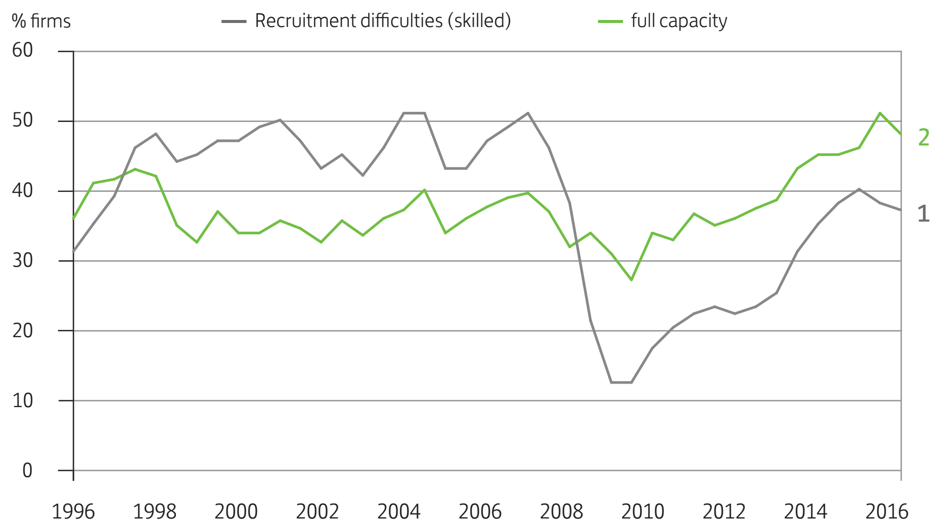
INVESTMENT AND EMPLOYMENT IN THE NEXT SIX MONTHS



1. For the first time since 2012, the net balance of firms expecting to increase their staffing numbers fell in negative territory, to **-1%**. This has yet to be reflected in the official statistics, but could signify a fall in employment growth. Twenty-one percent (down from 26%) of firms look to raise their staffing numbers, while 22% (up from 13%) are preparing to reduce their headcount.

2. With economic uncertainty having increased following the EU referendum, the net balance of companies looking to increase their capital expenditure fell to **0%**. This is the weakest level for four years, but is still well above the lowest point during the global financial crisis. Twenty-four percent (down from 28%) of firms intended to raise investment spending, while 24% (up from 14%) also anticipate a reduction.

RECRUITMENT FRICTIONS AND CAPACITY TRENDS



1. For the second consecutive survey, there was a fall in the proportion of firms reporting difficulties in recruiting skilled workers. The decline to **38%** is a two-year low and it remains below the pre-crisis average of above 45%, but it is still well above levels seen during the global financial crisis. Notably, the share of companies expecting average pay to rise in the coming six months has also fallen.

2. The share of businesses indicating that they are operating at full capacity fell back to **49%** from the all-time high in the last survey. It remains at a high level historically, but has not so far corresponded with higher pricing pressures.

-1% The net balance of firms expecting to increase their staffing numbers in the next six months fell from 13% to **-1%**.

0% The net balance anticipating an increase in capital spending fell from 14% to **0%**.

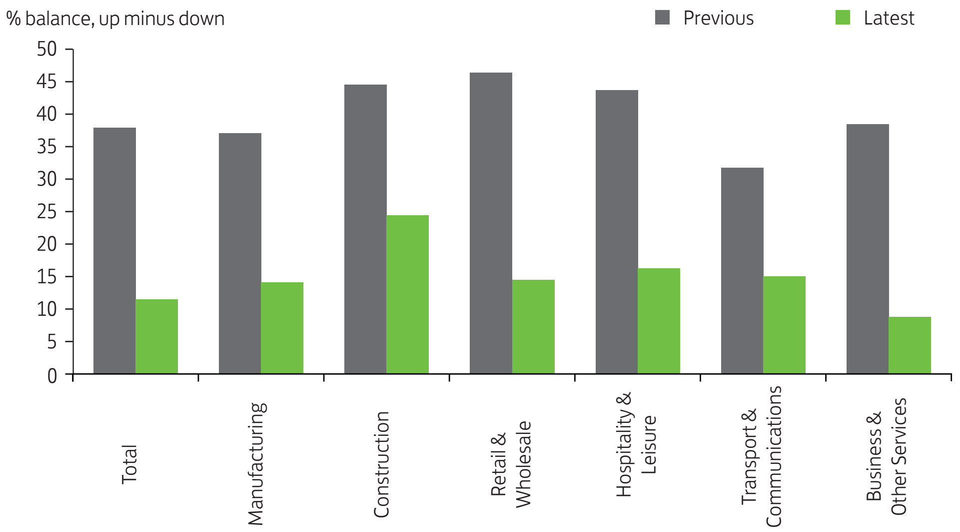
38% The proportion of firms reporting difficulties in recruiting skilled workers in the past six months decreased from 39% to **38%**.

49% The share of firms reporting that they are operating at full capacity fell from 52% to **49%**.

THE SECTORAL PICTURE

DECLINE IN CONFIDENCE IMPACTS ON ALL SECTORS

BUSINESS CONFIDENCE

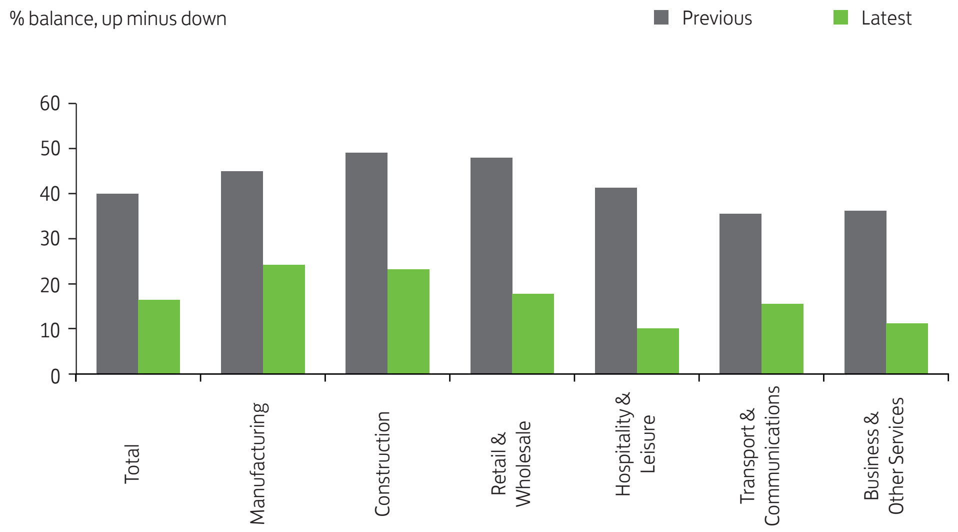


The significant decline in business confidence in the economy as a whole was replicated across all sectors. In all cases, however, confidence levels remained in positive territory and may be more consistent with a slowdown in growth in activity rather than a rapid decline.

There were particularly large falls in sentiment in the service sectors, including retail & wholesale (down 33 points to 14%), hospitality & leisure (down 28 points to 16%), and business & other services (down 30 points to 8%), although the exception was the smaller decline in transport & communications (down 17 points to 15%).

Sentiment also fell in construction (down 21 points to 23%), though the level remains relatively high from a historical perspective. Manufacturing (down 23 points to 14%) also recorded lower confidence, despite the potential benefit from sterling's depreciation.

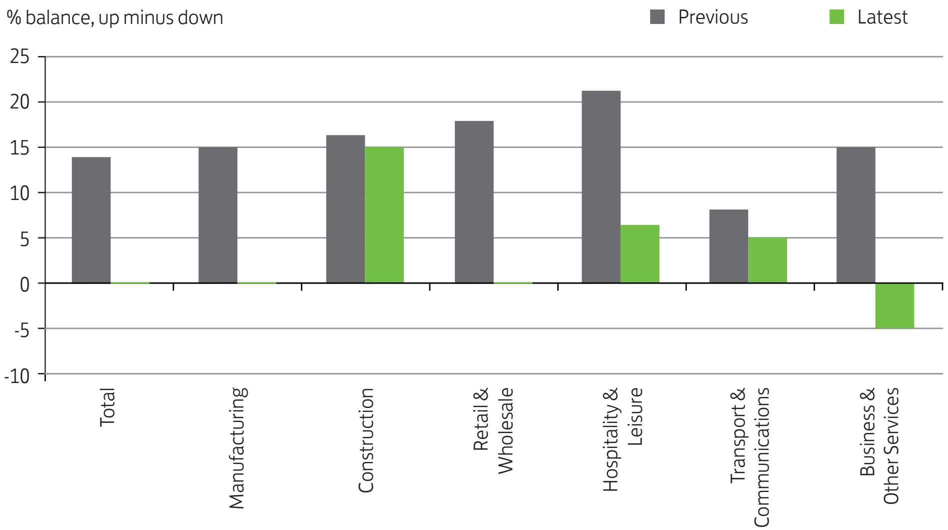
TOTAL ORDERS IN THE NEXT SIX MONTHS



The deterioration in business confidence reflects in part a sizeable decline in orders expectations for the next six months. The largest declines were in hospitality & leisure (down 31 points to 10%) and retail & wholesale (down 30 points to 18%), while manufacturing (down 22 points to 23%) and transport & communications (down 19 points to 16%) reported smaller falls. In all cases, orders are still well above the levels touched during the last recession.

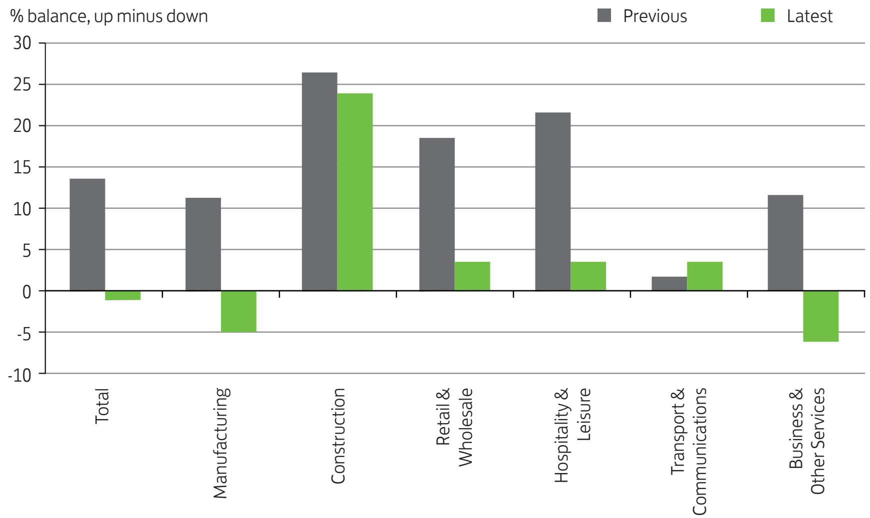
MOST SECTORS NOW MORE CAUTIOUS ABOUT SPENDING & HIRING

CAPITAL SPENDING IN THE NEXT SIX MONTHS



The decline in business sentiment is reflected in cutbacks to capital spending plans for the next six months. As a result, investment spending plans in most sectors are at their lowest level since 2012. The biggest declines were in business & other services (down 20 points to -5%) and retail and wholesale (down 18 points to 0%). In contrast, the net balances fell only modestly in transport & communications (down 3 points to 5%) and construction (down 1 point to 15%).

EMPLOYMENT INTENTIONS IN THE NEXT SIX MONTHS

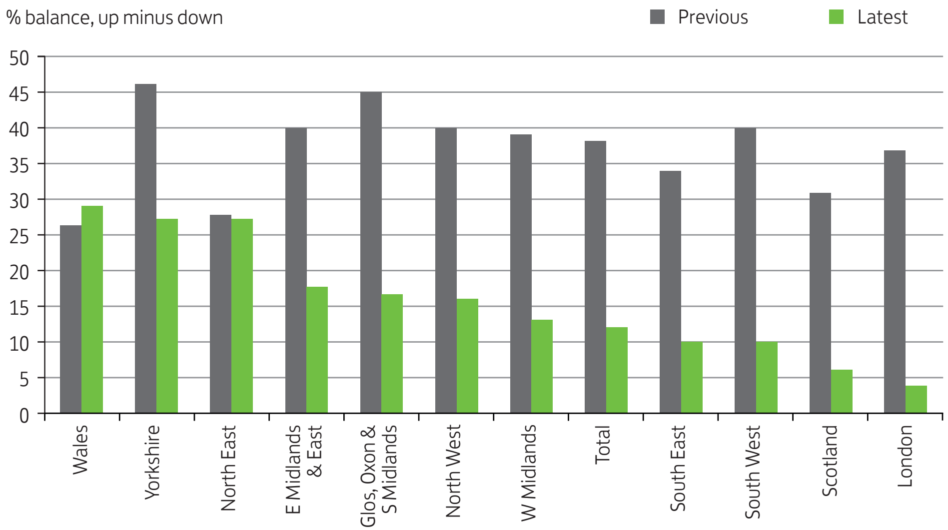


Firms in most sectors expect to scale back plans for any expansion of their workforce in the next six months. The largest falls in the share of companies expecting to increase their staff numbers were in business and other services (down 18 points to -6%) and hospitality & leisure (down 19 points to 3%). In contrast, the net balance rose slightly in transport & communications (up 1 point to 3%), while it fell only marginally in construction (down 2 points to 24%). Construction also stands out as firms in this sector continue to expect employment improvements that are close to recent highs.

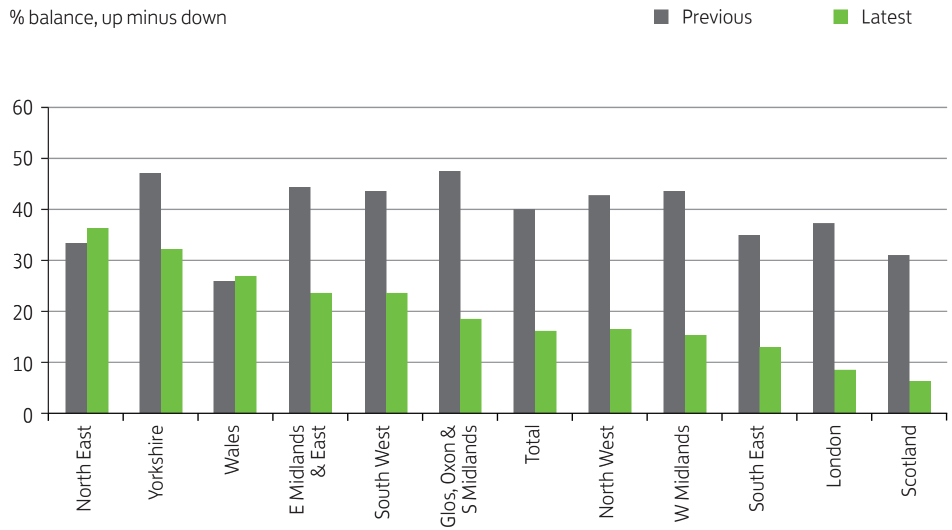
THE REGIONAL PICTURE

CONFIDENCE FALLS SHARPLY BUT NOT IN ALL REGIONS

BUSINESS CONFIDENCE



TOTAL ORDERS IN THE NEXT SIX MONTHS



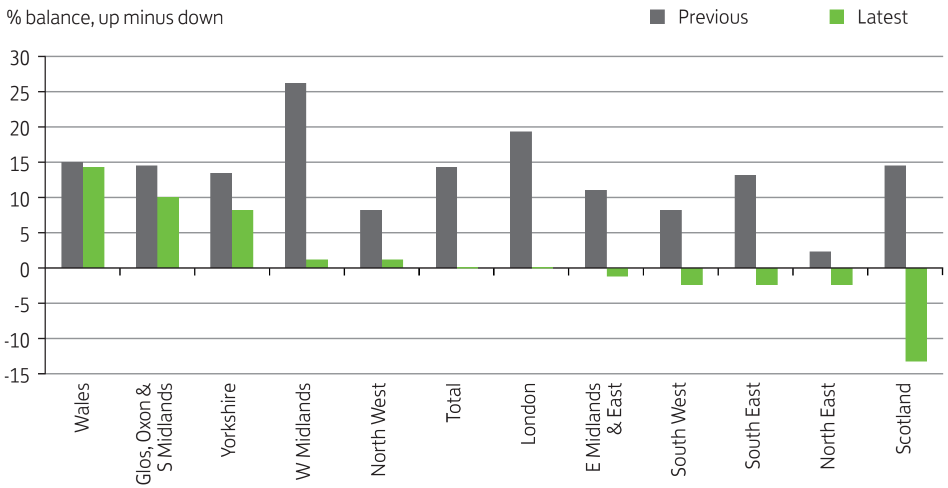
The latest survey shows a marked divergence in confidence across regions. Most English regions and Scotland have seen a sharp decline in confidence since the start of the year, while Wales bucked the trend and reported an improvement. The chart shows that confidence levels were below the national average in the south of England and Scotland, but above average in Wales, the Midlands and the North of England.

Sentiment may have been partly driven by the outcome of the EU referendum, with confidence levels the lowest in London and Scotland which voted for 'Remain'. There was a particularly marked fall in London (down 33 points to 4%), while the North East recorded only a minimal fall (down 1 point to 26%) and confidence in Wales (up 3 points to 29%) is higher than at the start of the year. The level of confidence in Yorkshire remains relatively high even though its balance is down by 19 points from the last survey.

The slide in business confidence reflects in part a significant deterioration in orders expectations for the next six months across most regions. With the exception of the North East and Wales, there have been marked falls in the net balances for orders, with the largest in London (down 29 points to 9%) and the smallest in Yorkshire (down 15 points to 32%). The sizeable deterioration in orders expectations in London and Scotland, compared with little or no deterioration in Wales and the North East, where a majority voted to leave the EU, suggests that the vote may have played a part in sentiment changes.

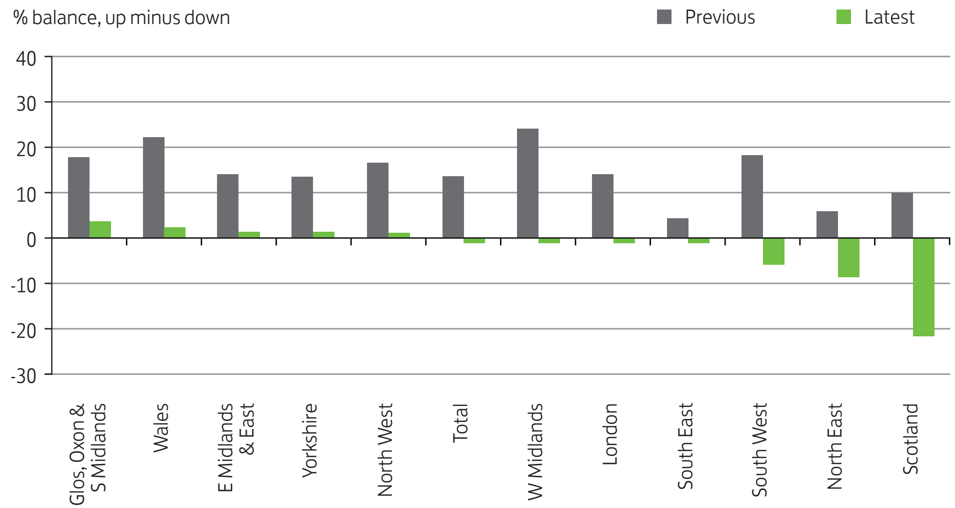
ALL REGIONS REPORT A MORE CAUTIOUS ATTITUDE TOWARDS HIRING

CAPITAL EXPENDITURE IN THE NEXT SIX MONTHS



The net balance of businesses that anticipate increasing capital spending over the next six months is lower in all regions and negative in some areas, notably Scotland. The West Midlands, London and the South East, along with Scotland, have seen falls of 15 points or more. In contrast, expectations in Wales are down by only 1 point and the North East, Gloucestershire, Oxfordshire and the South Midlands, and Yorkshire by 5 points or less.

EMPLOYMENT INTENTIONS IN THE NEXT SIX MONTHS



Employment expectations for the next six months have fallen sharply across most regions when compared to January. With the exception of the South East, the employment balance has fallen by 10 points or more in all English regions and in both Scotland and Wales, suggesting widespread caution about increasing staff levels in the second half of this year. Notably, employment expectations have fallen sharply even in the North East and Wales, where business confidence has seemingly remained relatively buoyant. Negative balances, particularly in Scotland, the North East and the South West, point to a possibility of layoffs in the second half of this year.

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