Recent Developments in Small Business Finance and Economic Conditions

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Abstract

The economic environment has become more challenging over the past year, including for small businesses. High inflation, slower growth of demand and difficulties in finding suitable labour have contributed to declines in small business conditions and confidence. Demand for business finance has slowed, consistent with the rise in interest rates and slower growth in economic activity. Small businesses report that accessing funding through banks remains a challenge. The article considers these recent developments, drawing on the discussions of the Small Business Finance Advisory Panel and information from the Bank's liaison program.

Introduction

In July 2023, the Reserve Bank convened its 31st Small Business Finance Advisory Panel to better understand the challenges faced by small businesses.[1] This year's panel focused on economic conditions for small businesses, their appetite to take on external funding and the challenges they encounter in accessing finance. The annual panel discussion complements other sources of information the Bank receives on small business conditions, including from its liaison program and private sector surveys.[2] This article draws on these sources and other data to provide an update on economic conditions for small businesses and recent developments in small business finance.

The contribution of small business to the Australian economy

There are around 2.6 million businesses in Australia. The vast majority of these – 97 per cent – have fewer than 20 employees, which the Australian Bureau of Statistics (ABS) uses as its definition for a small business.[3] Small businesses make up a large share of businesses across all industries (Graph 1).

The largest shares of small businesses are in the construction, and the professional, scientific and

Table 1: Distribution of Small Businesses in Australia, by Industry
Share of the total number of small businesses; 2022

	Per cent		Per cent
Construction	17.6	Accommodation and food services	4.1
Professional, scientific and technical services	13.0	Manufacturing	3.4
Rental, hiring and real estate services	11.4	Wholesale trade	3.2
Transport, postal and warehousing	8.4	Education and training	1.5
Agriculture, forestry and fishing	6.9	Arts and recreation services	1.4
Health care and social assistance	6.7	Information, media and telecommunications	1.0
Retail trade	6.0	Electricity, gas, water and waste services	0.3
Other services	5.1	Mining	0.3
Administrative and support services	4.7	Public administration and safety	0.3
Financial and insurance services	5.1		

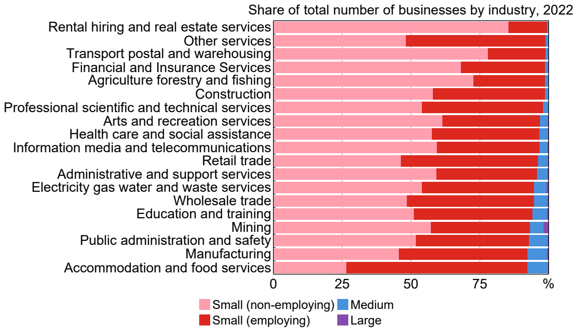
Sources: ABS; RBA.

technical services industries, which together make up more than 30 per cent of the total number of small businesses in Australia (Table 1). The rental, hiring and real estate services industry has the third largest number, representing 11 per cent of Australian small businesses.

Small businesses make up a substantial share of output, employment and income in the Australian economy. They account for around one-third of gross value added (which measures the production of goods and services, less intermediate inputs) (Graph 2). The estimated contribution of small businesses to private-sector employment is larger at around 42 per cent. Bakhtiari (2019) suggests that small, young firms contribute strongly to job creation, typically in their first two years of operation, and that four out of every five jobs added

Graph 1

Businesses in Australia
Share of total number of businesses by industry, 2022



Sources: ABS; RBA.

to the Australian economy have historically been created by these firms. Small businesses' share of total income has increased slightly over the past decade.

Outside of their directly measurable contribution to the economy, small businesses also play an important role in communities, particularly in regional areas. Small businesses provide goods and services to areas where larger firms may choose not to operate (since smaller markets might not generate enough revenue to cover the fixed costs of doing business there). On average, just over 30 per cent of small businesses are located outside of greater capital city areas, compared with around one-quarter of large businesses (Graph 3).

Small businesses, particularly sole traders, generally have lower survival rates compared with larger firms. Businesses may not survive due to several reasons, such as the retirement of the owner or business failure leading to insolvency. Data from the Australian Securities and Investments Commission indicate that, from 2013–2022, between 65 per cent and 70 per cent of firms that became insolvent in a given financial year had less than five full-time employees. For very small firms, recent experience has shown their survival rates are noticeably lower than that of larger firms (Graph 4). Since 2019/20, more than half of new sole traders did not survive beyond three years. Survival rates were higher for new small businesses with up to 20 employees, though still below the survival rates of medium and large businesses. Over this period, survival rates for established businesses were slightly better than for new businesses: around 60 per cent of sole traders that were already established in June 2019 (and around 75 per cent of established small businesses with employees) were still operating four years later.

Economic conditions for small businesses

Panellists from the Small Business Finance Advisory Panel highlighted a range of challenges for small businesses in the current economic environment, consistent with information from the Bank's liaison program and broader macroeconomic trends. Demand has eased as high inflation and the increase in interest rates have placed pressure on household budgets. However, the availability of labour has remained tight and, in some cases, has constrained firms' operations while also placing upward pressure on wages. In addition, the broad-based increase in costs and prices has contributed to cash flow problems for some firms and an increase in business insolvencies (from low levels during the COVID-19 pandemic).

Survey measures of current operating conditions for small businesses have declined since mid-2022. Reported conditions for smaller businesses are weaker compared with large firms (Graph 5). Business conditions are weakest for the smallest of firms as well as for retail businesses, with smaller firms in the retail sector finding conditions notably more difficult compared with larger retailers. Over recent quarters, small business confidence, which measures firms' views on their operating outlook for the next three months, has been slightly below both its long-run average and that of large firms. Business confidence is lower among retail firms relative to other industries; confidence levels are similar for small and larger retail firms.

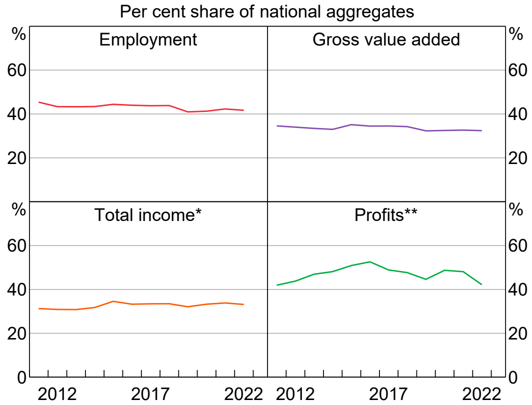
Demand

High inflation, higher interest rates and earlier declines in household wealth have weighed on consumption growth over recent quarters. Growth in aggregate retail sales values has also slowed

Graph 2

Small Business Share of the Economy

Per cent share of national aggregates



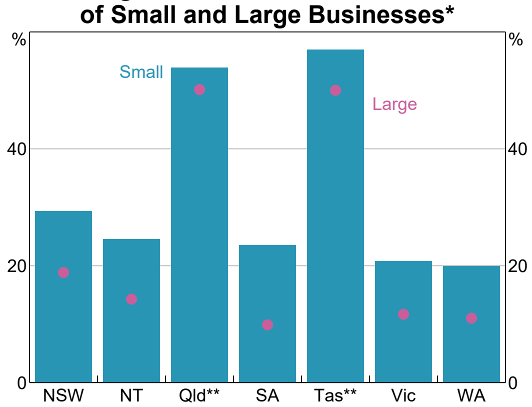
* Sales and service income, interest income, funding from government for operational costs and other income.

** Operating profits before tax.

Sources: ABS; RBA.

Graph 3

Regional Share of the Number of Small and Large Businesses*



* Share outside greater capital cities.

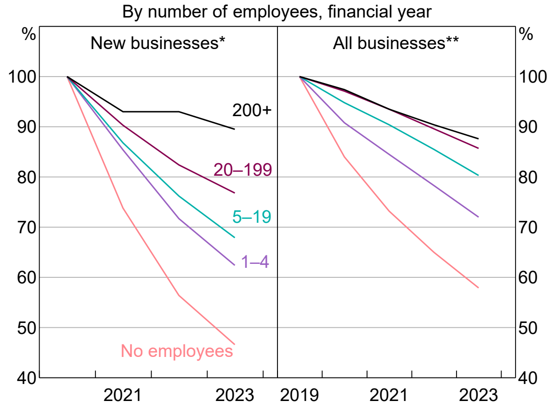
** In Queensland and Tasmania, the relatively higher share of businesses outside greater capital cities reflects firms operating in the Gold Coast, the Sunshine Coast and Launceston; if these three areas are excluded, the shares are similar to the other states.

Source: ABS; RBA.

Graph 4

Business Survival Rates

By number of employees, financial year



* Firms commencing operation in 2019/20.

** Firms operating at end June 2019.

Sources: ABS; RBA.

considerably over the past year and sales for small retailers have declined a little in year-ended terms (Graph 6). This slowing is consistent with recent messages from retailers in the Bank's liaison program, with firms reporting that household consumption has been subdued (RBA 2023b). Demand for new residential dwellings has also declined. Conditions have weakened for firms serving businesses, but to a lesser extent than for those serving households.

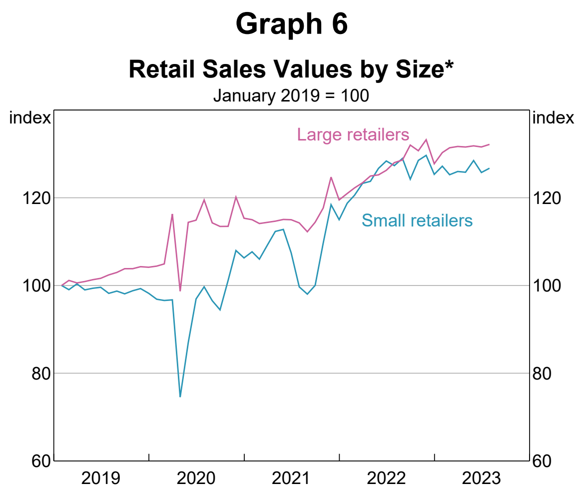
Consistent with information from liaison, the small business finance panellists described household and business customers as being more cautious with spending recently. Several panellists shared observations of their own customers seeking additional hours of work or a second job to maintain their level of consumption as living costs increased.

Labour market conditions

Panellists generally reported that acquiring labour had become a little easier in recent months, consistent with information from business surveys and the Bank's liaison program. Panellists thought that the increase in labour supply had been supported by the reopening of Australia's borders to inbound migration.

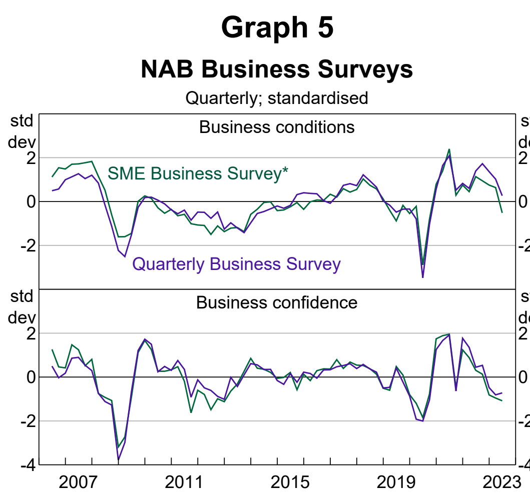
In contrast to the prior year, the appetite among panellists to increase the number of staff they employ in the year ahead was very low. They also noted that a number of businesses in the technology industry had already made, or were intending to make, redundancies following strong recruitment during the pandemic. The share of firms in the Bank's liaison program looking to increase staff headcount over the next 12 months has also declined over the past year, although most firms are still looking to either increase or maintain headcount over the year ahead (Graph 7).

Several panellists reported that their business had been affected by the recent increase in the award rate by the Fair Work Commission, including because some staff who are not on awards received a commensurate increase in wages. Some contacts report that wage pressures in the technology



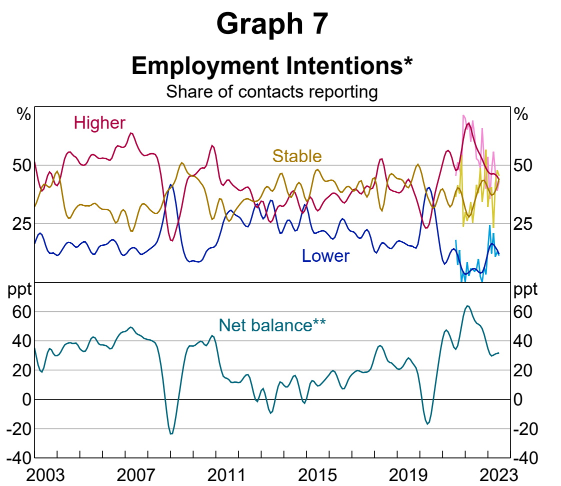
* The survey uses annualised turnover, based on the ATO's Business Activity Statement item Total Sales, as the measure of business size. Around 700 'large' businesses are included in the survey every month, while a sample of around 2,700 'smaller' businesses is selected. The 'large' business' contribution represents approximately 69 per cent of the total Australian turnover estimate.

Sources: ABS; RBA.



* NAB classifies small and medium businesses as having annual turnover of between $2 million and $10 million.

Sources: NAB; RBA.



* Over the year ahead; lighter lines in the top panel are monthly data for the past two years; all other lines are 13-month Henderson trends.

** Net balance = higher minus lower.

Source: RBA.

industry have eased significantly from the previous year.

Input costs, price-setting and cash flow pressures

Panellists generally characterised input price pressures as remaining elevated, with sharply higher insurance costs highlighted as one example. Higher interest rates were also adding to cost pressures for some panellists, though it was noted that this was not a main factor. In liaison, which covers firms of all sizes, many firms have reported an easing in growth in input costs over recent months due to a decline in the cost of imported goods. This was partly offset by continued growth in domestic input costs, particularly from higher energy prices, labour, transport and insurance.

In response to rising input costs and wage pressures, most panellists stated they had passed through higher prices to their customers, at least to some extent; some had less scope for this, however, because demand for their product was more price sensitive. Information from liaison has indicated that some small businesses have found it difficult to set prices in the current high-inflation environment and have consequently experienced unanticipated margin compression.

Panellists noted that there were other contributors to cash flow pressures. Late payments to small businesses were said to have become more common, and some commercial landlords had started to request large bonds to account for the risk of lost revenues if businesses stopped trading. Liaison with industry bodies has also indicated that the end of the Australian Taxation Office's tax arrears holiday has resulted in cash flow pressures for some small businesses, with some finding it difficult to repay tax that has accrued since the pandemic. Liaison also suggests some small businesses are conserving liquidity rather than investing, amid challenging business conditions.

The number of company insolvencies has risen sharply over the past year from very low levels; in several industries, they are currently around or above pre-pandemic levels (Graph 8). The construction sector has accounted for around 30 per cent of insolvencies over the past year, partly reflecting margin pressures as builders work through fixed-price contracts that were written before costs rose substantially over the past two years. Labour and materials shortages and poor weather conditions have also added costly delays, and while completion times have improved modestly of late, a return to more normal building times is not anticipated until 2024 (RBA 2023b). Business-related personal insolvencies – which capture insolvencies for unincorporated small businesses (e.g. sole traders) – have increased recently but remain near historical lows.

Demand for small business finance

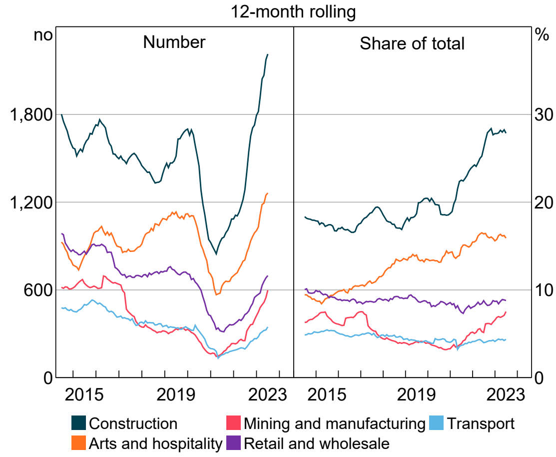
Loans to small and medium enterprises (SMEs) account for just over half of outstanding business loans in Australia. Lending to SMEs increased by 6 per cent over the past year; however, this was driven entirely by lending to medium businesses (Graph 9). Lending to small businesses has been little changed for the past decade.

Growth in overall business credit has slowed significantly since October 2022, although business credit growth and commitments for new business loans have been relatively stable in recent months. Lending to SMEs grew more slowly than lending to larger businesses over most of the past year (Graph 10). Slower growth for smaller businesses over the past year was most noticeable among the property services, retail and wholesale trade industries. Growth in lending to SMEs has increased

Graph 8

Company Insolvencies by Industry*

12-month rolling



* Selected industries.

Sources: ASIC; RBA.

in recent months, partly reflecting a seasonal pick-up in lending to the agriculture industry.

Consistent with these trends, the appetite for new finance among panellists was weaker than in the prior year. Panellists were not seeking finance to fund growth, although some panellists reported they were in the process of seeking working capital facilities for general operating expenses or to fund purchase of equipment.

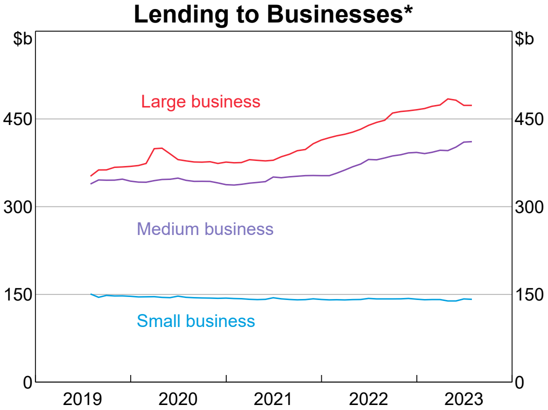
Borrowing costs for SMEs

Interest rates on business loans have risen over the past year, reflecting increases in the cash rate and bank bill swap (BBSW) rates (BBSW rates are the standard benchmark rates used to price loans to medium and large businesses). The average variable rate on new loans to SMEs has risen by around 360 basis points since the start of monetary tightening in May 2022; this is slightly lower than the 400 basis point increase for larger businesses (Graph 11). Panellists generally reiterated messages from previous years that the price of lending is not the biggest impediment to accessing finance, although some noted they had been unwilling to take on debt at the interest rates they had been offered (partly due to their unwillingness to use residential property as collateral, as discussed below).

Smaller businesses typically face higher borrowing costs than larger businesses. In part, this is because small businesses are more likely to default on average than large businesses; modelling by banks suggests that, on average, small businesses are around twice as likely to default as large businesses.[4] Average outstanding interest rates for SMEs were around 65 basis points higher than for large businesses in June 2023, well below the average of around 150 basis points in the decade prior to the pandemic (Graph 12). This historically low spread between interest rates for large and small businesses mainly reflects the fact that a higher share of SME credit was fixed at low interest rates during the pandemic and some of these loans are yet to roll off onto higher interest rates. Around one-third of small business credit is currently fixed rate; by comparison, less than 10 per cent of large business credit is fixed (although large businesses are also more likely to hedge their interest rate

Graph 9

Lending to Businesses*



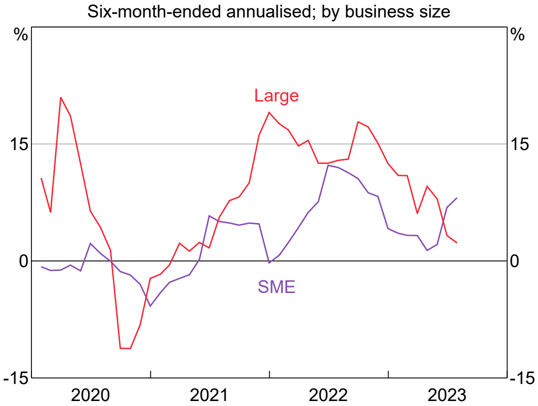
* Data cover financial institutions with $2 billion or more of business credit; not seasonally adjusted. Excludes loans to financial businesses. Data in April 2023 break-adjusted for revised definition of business sizes for IRB reporting institutions.

Sources: APRA; RBA.

Graph 10

Business Credit Growth*

Six-month-ended annualised; by business size



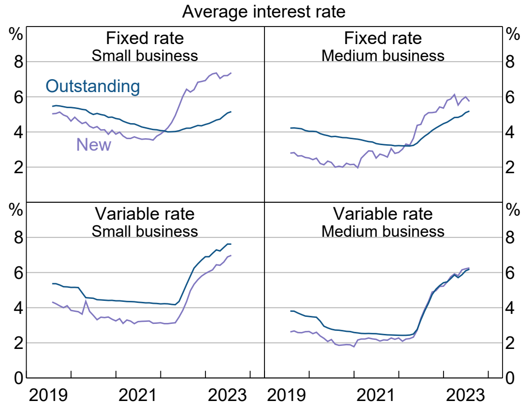
* Not seasonally adjusted.

Sources: APRA; RBA.

Graph 11

SME Lending Rates

Average interest rate



Sources: APRA; RBA.

exposure and/or borrow using fixed-rate bonds) (RBA 2023a).

Access to credit from banks

For many years, small businesses have reported that they find it difficult to access finance from traditional lenders with terms that suit their needs. A recent survey of SMEs found that around half had faced difficulties when trying to obtain funding, with the most common challenge being the time taken to process applications (Banjo Loans 2023). Panellists stated that access to bank finance had become more difficult recently, reflecting the slowing economic environment. Panellists believed banks were tightening lending standards by scrutinising business financial statements more closely. In liaison, banks have reported being more cautious with lending to sectors that are more exposed to a slowing economy, such as those that rely more heavily on discretionary spending.

The requirement to provide residential property as collateral has long been cited as the key constraint on access to finance for some SMEs.[5] This can also heighten the challenges faced by First Nations business owners in accessing finance, as First Nations people have around half the home ownership rate of other Australians (National Indigenous Australians Agency 2021).[6] Similar to previous years, some panellists noted they were unable to secure finance at an acceptable interest rate or in sufficient volumes without providing residential property or other physical assets as collateral. Some panellists were unwilling to provide residential property as collateral and did not have other physical assets to use instead (such as commercial property or equipment). This meant they faced much higher interest rates on their loans. Interest rates on small business loans secured by residential property are around 50 basis points lower than loans secured by other assets on average, and roughly 3 percentage points lower than unsecured loans (Graph 13). Residentially secured loans are also larger on average, and account for just under half of total outstanding small business loans by value.

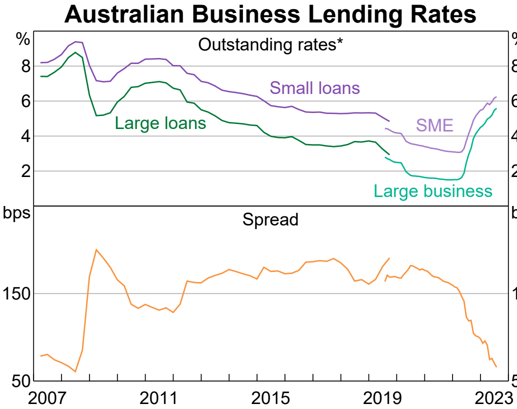
Reductions to the Australian Prudential Regulation Authority's capital requirements for banks' SME loans became effective from January 2023. These changes lowered the risk weights on loans to SMEs, reducing the amount of capital banks are required to hold against these loans. They also revised the definition of retail SMEs, which attract lower capital requirements than loans to non-retail SMEs, to include loan exposures of up to $1.5 million. Lower capital requirements reduce the cost to banks of funding SME loans (all else equal), which may support lending to small businesses.

New lenders and other sources of finance

Several lending options beyond traditional property-secured loans have become available to SMEs in recent years, which have helped improve some SMEs' access to finance (Productivity

Graph 12

Australian Business Lending Rates

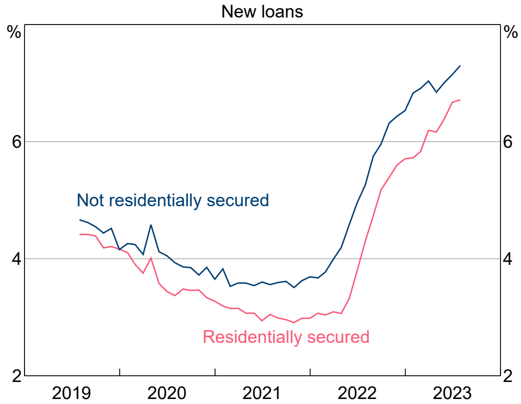


* Small loans data up to June 2019 reflect loans valued less than $2 million; large loans data up to June 2019 reflect loans valued $2 million or more; from July 2019 new data are used from the Economic and Financial Statistics (EFS) collection (see Statistical Table F7).

Sources: APRA; RBA.

Graph 13

Small Business Lending Rates



Sources: APRA; RBA.

Commission 2021). A range of non-bank lenders are offering tailored loans and services to SMEs, commonly using new technologies to assess creditworthiness and allow SMEs to access finance more quickly and/or with less collateral than through banks. While these products have provided businesses with alternative sources of finance, the amount of funding obtained through these sources remains modest compared with bank lending.

Private equity finance

Small businesses typically have access to a narrow pool of equity funding compared with larger companies. Private (i.e. unlisted) companies in Australia can only raise equity investments from professional and sophisticated investors, small-scale personal offers or crowd-sourced equity funding. Nevertheless, several panellists noted a preference for equity over debt, including because it provided greater flexibility during the early stages of a business and because of the strategic guidance offered by some private equity investors.

Panellists noted that conditions in private equity markets had tightened over the past year. Equity valuations had declined, particularly for technology companies. Private equity and venture capital investors were also described as more risk averse, particularly for businesses with considerable exposure to consumer spending. As a result, due diligence had become more intensive and was very time consuming. For some panellists, these factors had caused them to withdraw from the process of seeking private equity finance. Data on private capital markets – which are heavily skewed towards investment in larger businesses – indicate that investment activity declined slightly in 2022 (Preqin and Australian Investment Council 2023) (Graph 14).

Non-traditional finance

Consistent with global trends, Australia's non-traditional finance market has grown in recent years. One source of this is balance-sheet lending by technology or payments firms, whereby these firms use their transactions data to identify creditworthy business borrowers and then provide loans and trade credit from their own balance sheets. These lenders typically have higher funding costs and charge higher interest rates than banks.

Crowd-sourced equity funding allows SMEs to issue shares to the public via online platforms. The panel's experience here was that public investors were less likely to challenge valuations relative to sophisticated private equity investors, and they were largely passive (requiring less time from business owners). While crowd-sourced equity funding has grown in Australia over recent years, aggregate amounts of this remain small. Australian SMEs have raised around $219 million via this channel since 2018, with around $70 million raised through 91 deals in 2022 (Birchal 2022).

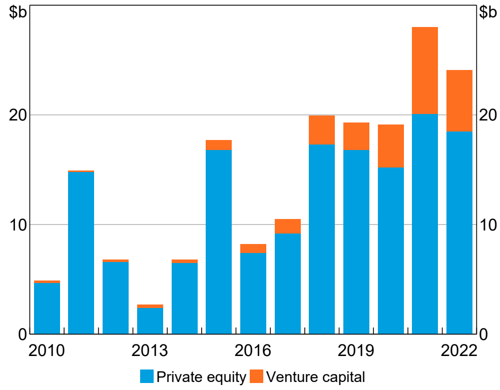
Conclusion

Small businesses play an important part in the Australian economy, both through their economic contributions and their role in local communities. Small business conditions and confidence have declined over the past year reflecting weaker demand, rising input costs and continued difficulty in finding suitable labour. Demand for business finance has eased following the increase in interest rates and the slowing in economic activity, with lending to SMEs growing more slowly than large business lending until recently. Small businesses report that accessing finance through traditional lenders remains difficult. While new lenders and products are providing businesses with alternative sources of finance, the amount of funding obtained through these sources remains modest compared with bank lending.

Graph 14

Private Equity and Venture Capital*

Deals in Australia



* Excludes add-ons, grants, mergers, secondary stock purchases, and venture debt.

Sources: Australian Investment Council; Preqin; RBA.

Endnotes

[*] The authors are from Economic Analysis and Domestic Markets departments. They would like to thank the members of the Small Business Finance Advisory Panel for their participation in this year's discussion.

[1] The 2023 panel comprised nine entrepreneurs, covering New South Wales, Victoria, Queensland, the ACT, Western Australia and South Australia as well as multiple industries (hospitality, insurance, advertising, construction, retail, IT and household services), including one First Nations member.

[2] See RBA (2022) for further information on the Bank's liaison program.

[3] The ABS defines a medium-sized business as having between 20 and 199 employees (inclusive), and a large business as having more than 200 employees. In APRA's lending data, for the largest reporting entities a business is classified as small or medium if it has an annual turnover of less than $75 million; within this, a business is considered small if it has an exposure to the reporting lending entity of less than $1.5 million.

[4] For this modelling, the definition of a small business is the SME retail and SME corporate categories in APRA's capital framework, which includes businesses with annual turnover of less than $75 million. Large businesses are those with more than $75 million in annual turnover.

[5] The Reserve Bank's liaison with lenders and businesses has highlighted that the availability of housing collateral by small business borrowers has a significant effect on the cost and availability of debt finance. See Connolly, La Cava and Read (2015).

[6] Information from the finance industry, Australian Government publications and Reserve Bank liaison suggest several possible reasons for lower rates of home ownership for First Nations Australians, including differences in demographics, geographic location, access to mortgage advisors and brokers, and income levels. See Australian Government (2010).

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