Small Business Economic and Financial Conditions

Geneve Bullo, Andre Chinnery, Siddarth Roche, Emma Smith and Peter Wallis*

Photo: Vladimir Vladimirov – Getty Images

Abstract

The economic environment has been challenging for many small businesses over the past year. Growth in demand has slowed while input costs remain elevated, putting pressure on profitability – particularly for businesses reliant on discretionary consumer spending. Even so, profit margins remain around pre-pandemic averages for most small businesses. While access to credit remains a challenge for small businesses, many accumulated sizeable cash buffers during the pandemic, contributing to their resilience over the past few years. The unevenness in small business conditions has been reflected in some continuing to perform well, while others have had to draw down on cash buffers and an increasing share have entered insolvency. However, the number of insolvencies remains below its pre-pandemic trend on a cumulative basis. This article discusses small business conditions in Australia by drawing on information from the Reserve Bank's 32nd Small Business Finance Advisory Panel, firm-level administrative data and other economic surveys.

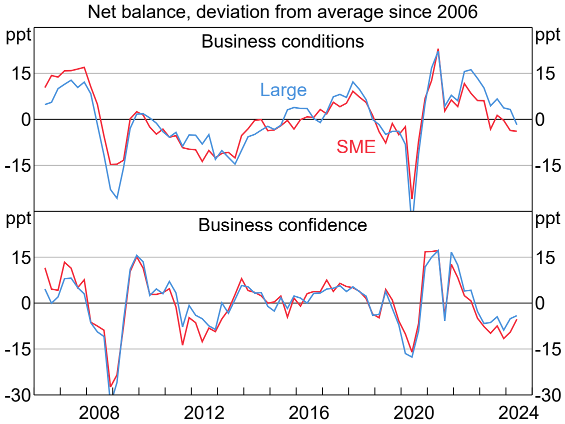
Introduction

The economic environment has been challenging for many businesses over the past year. Demand growth has continued to slow, growth in input costs has remained elevated, and higher interest rates have continued to flow through to indebted businesses' expenses (RBA 2024b). These pressures have been particularly challenging for small businesses but they have been felt unevenly between and within industries. Survey measures of operating conditions have continued to decline for small businesses and remain a little weaker than for large businesses (Graph 1, top panel).[1] Expectations of future business conditions among small businesses also remain below historical averages (Graph 1, bottom panel). Understanding these developments is important because small businesses make up a substantial share of output, employment and income in the Australian economy (Chan, Chinnery and Wallis 2023). They also support innovation and play an important role in communities, particularly in regional areas (Jones 2024).

Graph 1

Business Sentiment*

Net balance, deviation from average since 2006



* Quarterly survey. SMEs have turnover less than $5 million; large businesses have turnover between $5 and $10 million. Latest observation June 2024.

Sources: NAB; RBA.

In July 2024, the RBA convened its 32nd annual Small Business Finance Advisory Panel to discuss the provision of finance and the economic environment for small businesses. This article provides an update on economic and financial conditions for small businesses, drawing on information from this year's panellists as well as new analysis using firm-level administrative data, information from the RBA's regular liaison program and other economic surveys.

Economic conditions have been challenging for many small businesses

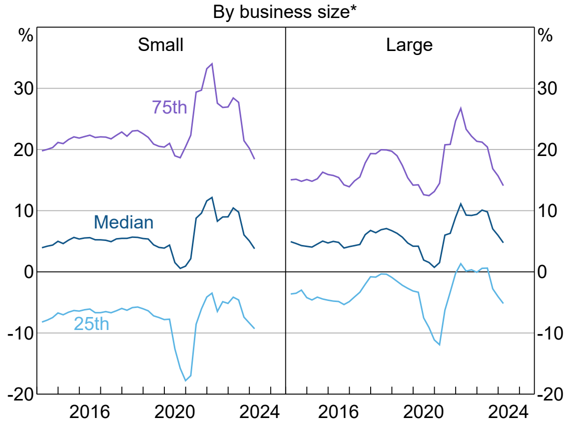
Demand growth has slowed from high levels, though the impact has been uneven across industries and between firms

Growth in demand – and, correspondingly, revenues – has slowed for most small businesses over the past year (Graph 2). Growth in household consumption remains well below pre-pandemic averages, as high inflation and higher interest rates have weighed on disposable incomes and consumer spending. Business investment growth has also started to moderate (RBA 2024b). However, as usual, small business performance has varied widely – more so than for large businesses (see dispersion in Graph 2 and discussion below).

Graph 2

Annual Revenue Growth Distribution

By business size*



* Year-ended revenue, seasonally adjusted. Small businesses have 5–19 employees; large 200+. Latest observation March 2024.

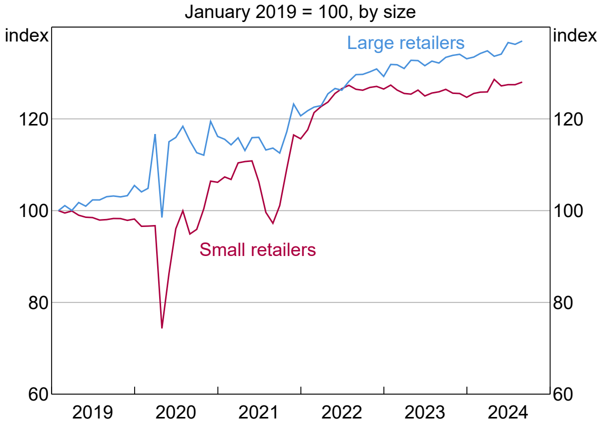
Sources: ABS (BLADE); RBA.

Conditions have varied by industry, with small businesses reliant on discretionary consumer spending, such as those in hospitality and retail trade, particularly impacted by softer demand. Growth in aggregate retail sales for smaller businesses has been subdued over the past year due to households reducing non-essential spending and trading down to cheaper items. This is especially true when compared with larger businesses (Graph 3). Survey measures of current operating conditions are softest for small businesses operating in accommodation and food (NAB 2024). This is consistent with revenue growth for many small businesses in these sectors close to or below zero over the past year (Graph 4, left panel). By contrast, revenue growth for many small construction companies and professional services firms has slowed to a lesser extent and remained solid, with the median growth around 6 per cent (Graph 4, right panel). Nonetheless, some construction firms are facing cash flow pressures from higher costs and payment delays (discussed later).

Graph 3

Retail Sales Values

January 2019 = 100, by size



* 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. This series has been seasonally adjusted by the RBA. Latest observation August 2024.

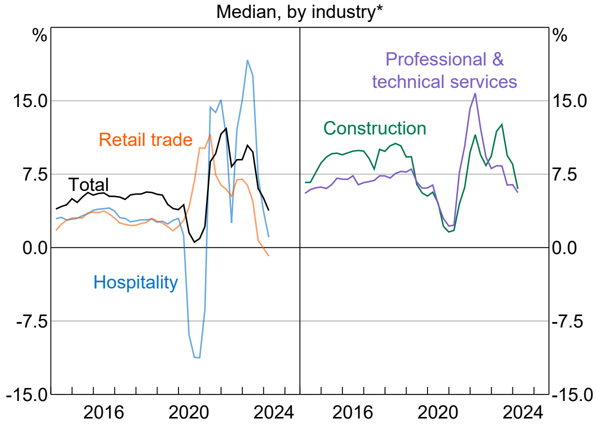
Sources: ABS; RBA.

As demand growth has slowed from very high levels, the share of small businesses experiencing very high or very low growth are back near historical averages in most industries. The share of high growth small businesses – those with three-year annualised revenue growth greater than 20 per cent – increased to a record high of 18 per cent in the period immediately after the pandemic, owing to the strong economic recovery (Graph 5, left panel). This share has now returned to pre-pandemic levels of around 12 per cent, and remains higher than for large businesses – as has been the case over the past decade. High-growth firms contribute significantly to innovation, as well as growth in sales, employment and exports (Majeed *et al* 2021).[2] The concentration of high growth small businesses within most industries remains around historical averages. One notable exception, however, is hospitality, where the share of high-growth firms (14 per cent) is above its historical average (9 per cent). This highlights the fact that some small cafes and restaurants continue to perform well, despite challenging conditions in the sector.

Graph 4

Small Business Annual Revenue Growth

Median, by industry*



* Year-ended revenue, seasonally adjusted. Selected industries shown. Small businesses have 5–19 employees. Latest observation March 2024.

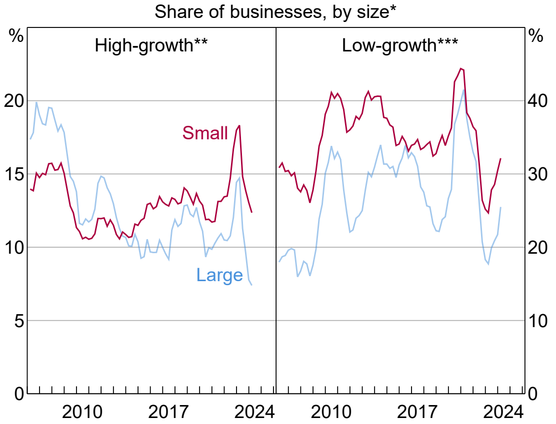
Sources: ABS (BLADE); RBA.

While the share of high-growth businesses has fallen, the share of low-growth businesses – those with three-year annualised revenue growth less than or equal to zero percent – has increased from low levels, to around one-third (Graph 5, right panel). This share remains a little below pre-pandemic averages but higher than larger businesses – again, as is generally the case. The distribution of low growth small businesses within most industries remains around historical averages. Some exceptions are rental, hiring and real estate services, agriculture, and retail trade, which have slightly higher concentrations of low growth businesses than their historical average.

Graph 5

High and Low Growth Firms

Share of businesses, by size*



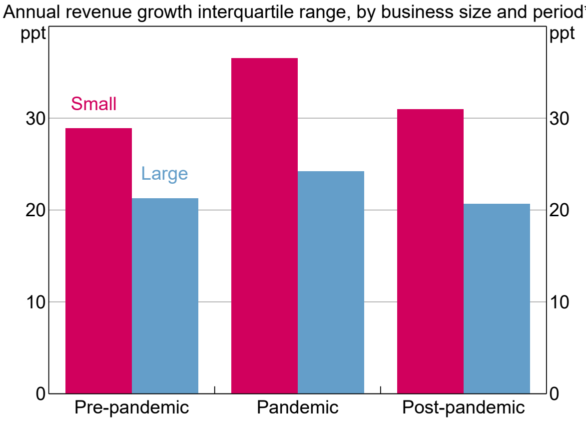
* Small businesses 5–19 employees; large businesses 200+. Latest observation March 2024.
** Three-year annualised revenue growth > 20 per cent.
*** Three-year annualised revenue growth <= 0 per cent.
Sources: ABS (BLADE); RBA.

Many small businesses experience large fluctuations in revenue growth year to year, contributing to cash flow challenges. Small businesses typically experience a wider range of annual revenue changes than larger businesses (Graph 6; Graph 2). This indicates that small businesses have more variable trading conditions year to year relative to larger businesses, including those operating in the same industry. Higher revenue variability is one factor that can make accessing financing more difficult, as lenders find it challenging to forecast future cash flows (see 'Access to finance remains difficult for small businesses' below). Variable cash flows can also be a source of financial stress for businesses, particularly those with smaller cash buffers and limited access to finance.

Graph 6

Revenue Variability

Annual revenue growth interquartile range, by business size and period*



* Pre-pandemic variability is the average from September 2004 to March 2020; pandemic is June 2020 to March 2022; post pandemic is after June 2022. Small companies have 5–19 employees; large companies have 200+ employees.
Sources: ABS (BLADE); RBA.

Operating cost growth has remained elevated and hiring intentions have eased …

Domestic input cost growth remains elevated. Business liaison, which cover firms of all sizes, report that while growth in non-labour costs is slower than a year ago, it remains above its long run average.[3] Both liaison participants and panellists from the Small Business Finance Advisory Panel point to higher logistics, energy and insurance costs as contributing factors. They also report that compliance costs remain elevated.

Labour costs remain above their long-run average and are expected to remain so over the coming year. While finding suitable labour continues to be difficult for many firms, labour availability has risen compared with a year ago. Voluntary staff turnover rates have fallen and panellists report that competition for higher income workers has eased a bit.

In response to elevated cost pressures (and weaker demand), many small businesses are looking to cut costs, including by decreasing employment (Banjo Loans 2024). Employment intentions are below historical averages and a slightly larger share of liaison participants (again, covering firms of all sizes) have reported their intention to decrease headcount. Other survey indicators suggest that fewer small businesses have increased headcount recently compared with larger businesses (NAB 2024). Small business finance panellists also referred to other cost-cutting measures, including increasing automation, cutting IT expenditure, and investing in new manufacturing centres to reduce transport costs.

Survey measures suggest many small businesses will focus on cost cutting over the year ahead (Banjo Loans 2024).

… but profitability has been maintained, as businesses have passed on higher costs

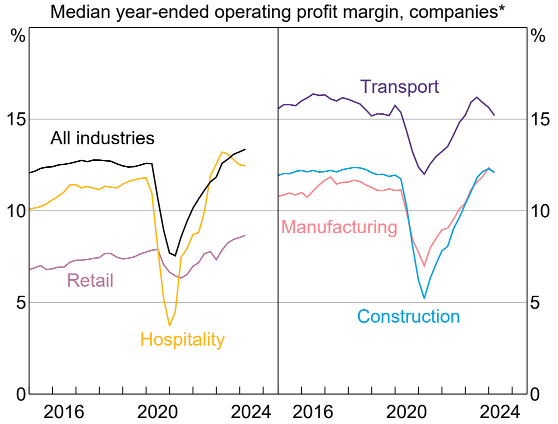
Profit margins are around their pre-pandemic averages for most small businesses (Graph 7). Strong demand following the pandemic enabled many businesses to pass on higher input costs. However, more recently, some small businesses have had less scope to pass cost increases on to customers compared with last year, especially those exposed to producing, distributing, and selling discretionary products and services. This is consistent with small declines in margins in hospitality and transport.

A sizeable share of small businesses are not very profitable or make losses, so they are quite vulnerable to a deterioration in economic conditions. The median small and large business generally reports comparable levels of profitability, incorporating both the margin and volume of goods and services sold (Graph 8, middle panel). However, top and bottom performers (i.e. the top and bottom quartiles) have quite different profitability across business size. While small businesses report a higher level of profitability for top performers (Graph 8, right panel), the bottom 25 per cent tend to make no (or negative) profits (Graph 8, left panel). This is especially true among the very smallest (micro) firms.[4] Small businesses with weak profitability are particularly vulnerable to deterioration in economic conditions.

Graph 7

Small Business Profit Margins

Median year-ended operating profit margin, companies*



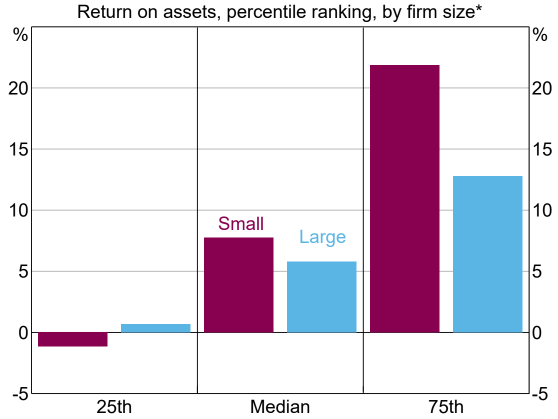
* Selected industries; net profits as year-ended operating revenue less operating costs and wages; not including government payments (e.g. JobKeeper); includes ~250,000 GST-remitting companies; seasonally adjusted. Latest observation March 2024.

Sources: ABS (BLADE); RBA.

Graph 8

Profitability Distribution

Return on assets, percentile ranking, by firm size*



* Return on assets is profits over total assets. Results based on historical averages from 2004–2022. Small companies have 5–19 employees; large companies have 200+ employees.

Sources: ABS (BLADE); RBA.

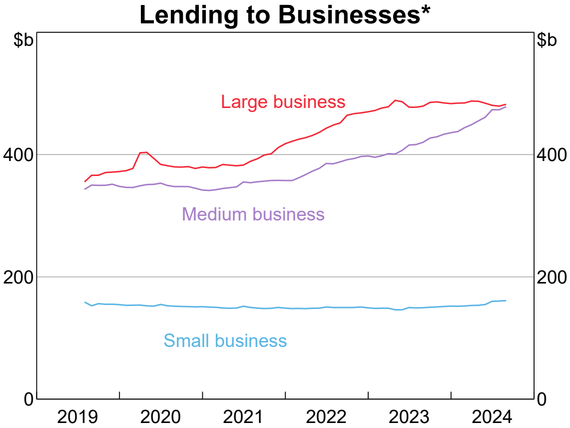
Increases in the cash rate have led to tighter financial conditions for small businesses

Access to finance remains difficult for many small businesses

For many years, small businesses have found it difficult to access finance with terms that suit their needs.[5] Common challenges include strict lending criteria, high interest rates, and the requirement to provide personal assets or property as collateral (Jones 2024; Banjo Loans 2024). In part reflecting these challenges, the value of outstanding small business loans – defined as smaller loans to small and medium enterprises (SMEs) – has been relatively stable for several years (Graph 9); in real terms, this implies a decline in the stock of small business loans. Over the past year, overall lending to SMEs has picked up, growing by 12 per cent and around 25 per cent since the start of 2022. Growth in lending to SMEs over the past year has been driven by medium-sized business loans in the property services, retail and wholesale trade, and agriculture industries.

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. Small and medium business loans are those to businesses with $75 million or less in consolidated annual revenues; within this category, small business loans are those where the lender has $1.5 million or less in loan exposures to the borrower. Business size definitions have changed over sample period.

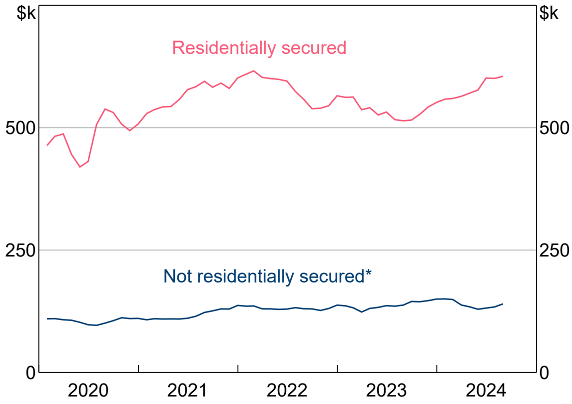
Sources: APRA; RBA.

Small business finance panellists reported that financial conditions had tightened over the past year. Panellists described lenders applying stricter criteria across a range of products, even though lenders have generally reported little change in lending standards. Several panellists had chosen to fund their business largely with equity because they were unwilling to pledge their family home as collateral (and had no other suitable assets) or because loans were too inflexible or risky in an uncertain economic environment. Just under half of all small business credit is secured with residential property, and businesses can obtain larger loans on average if they are willing and able to pledge residential property as collateral (Graph 10).

Graph 10

Average Small Business Loan Size

New loans; 3-month moving average



* Excluding credit cards.

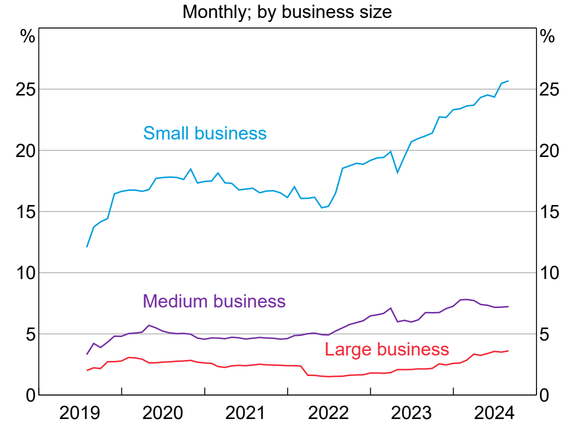
Sources: APRA; RBA.

Banks provide most small business finance but non-banks have increased their market share over recent years (Graph 11). Information from liaison with banks and market reporting has suggested some non-banks have competed more aggressively for small and medium-sized business loans, in part due to a decline in market share in the residential mortgage market reflecting heightened competition from banks. The increase in non-bank SME business credit since 2022 has been broadly based across most industries, with the exception of lending to the property services industry. Most non-bank lending to small businesses is for purchases of plant and equipment (including vehicle financing), while new lending from banks is more concentrated in loans for the purchase of property.

Graph 11

Non-bank Share of Business Lending*

Monthly; by business size



* Not seasonally adjusted or break-adjusted. Business size definitions changed in April 2023 and July 2024.

Sources: APRA; RBA.

Trade credit, which involves businesses extending credit to each other by delaying payments, has become a more important source of finance recently. Some panellists preferred trade credit to bank credit facilities because it was more flexible, despite being similarly costly. For some panellists, the increased use of trade credit was a response to increased cash flow pressures, including because of late payments from their own customers. Aggregate trade credit across private non-financial businesses has grown strongly over the past few quarters. The average time for small businesses to be paid and total late payments remain well below their pre-pandemic averages (Xero 2024).

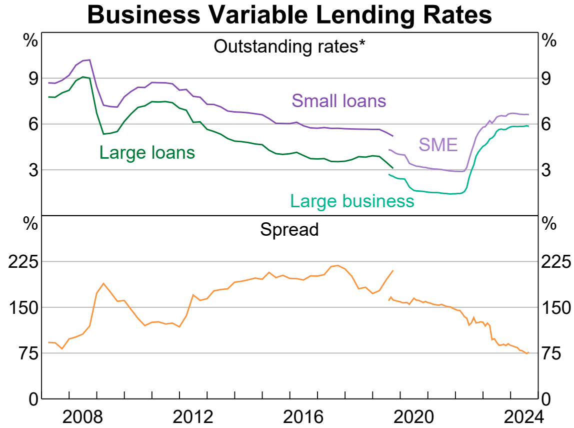
Another source of credit for small businesses is debt owed to the Australian Taxation Office (ATO). Debts to the ATO increased through the pandemic period as the ATO paused debt recovery actions. The level of unpaid debts remains high, the majority of which is owed by small businesses.

Smaller businesses continue to face higher borrowing costs than larger businesses

Smaller businesses typically face higher borrowing costs than larger businesses, although this spread has narrowed over recent years. Higher costs largely reflect banks' responding to their assessment of the greater risk of lending to SMEs. In particular, their risk modelling suggests that small and medium businesses are more likely to default than large corporations. Even so, the difference between rates on outstanding large and SME business loans has narrowed by around 120 basis points over the past two years, as rates on large businesses loans have risen by more than those on SME loans in the recent hiking phase (Graph 12). This trend partly reflects changes to business size definitions in April 2023 and June 2024 that resulted in some large business loans (which pay lower interest rates on average) being reclassified as SME loans. However, it could also reflect higher competition for SME lending (relative to large business lending) over this period, facilitated by improved funding conditions for non-bank lenders. Reductions to the Australian Prudential Regulation Authority's capital requirements for banks' SME loans, which became effective from January 2023, may also have contributed to this trend.[6] Rates on new SME loans have been little changed over the past year but have increased by around 365 basis points since April 2022, compared with around 415 basis points for new large business loans.

Graph 12

Business Variable Lending Rates



* Changes to business size definitions in April 2023 and July 2024 resulted in some large business loans being reclassified as SME loans.

Sources: APRA; RBA.

Strong financial positions have supported resilience but some small businesses have faced severe financial pressures and entered insolvency

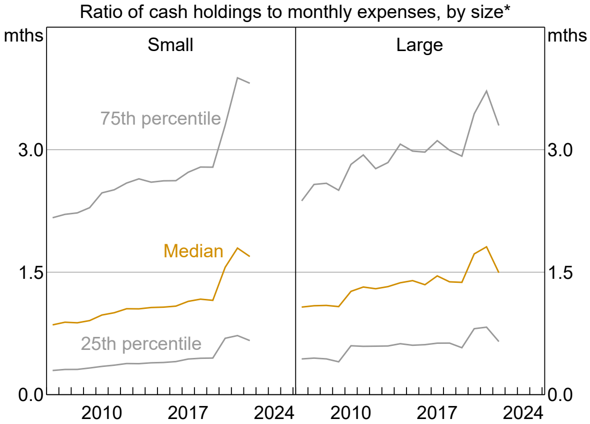
Cash holdings of small businesses have supported resilience

The sizable cash buffers accumulated during the pandemic have played a key role in small businesses' resilience through recent challenging conditions. While lagged, data available up to June 2022 on small businesses' cash holdings show the substantial buffers accumulated through the pandemic period, facilitated by significant pandemic support measures and precautionary saving (Graph 13). These buffers – measured as the ratio of liquid assets to monthly expenses – reached a similar level to those of larger businesses by the end of the pandemic period. By contrast, prior to the pandemic, the median small businesses had a cash buffer around 25 per cent lower than larger businesses. Many small businesses were able to pass on the increase in expenses observed in recent years, allowing them to maintain their cash buffers at near historical highs through to mid-2022. Cash buffers can be used to fund expansion. They can also be drawn on in periods of financial stress or to alleviate cash flow pressures arising from late payments.

Graph 13

Business Cash Buffers

Ratio of cash holdings to monthly expenses, by size*



* Small businesses are those with 5–19 employees; large 200+. Cash holdings estimated by subtracting inventories and accounts receivable from current assets. Latest observation June 2022.

Sources: ABS (BLADE); RBA.

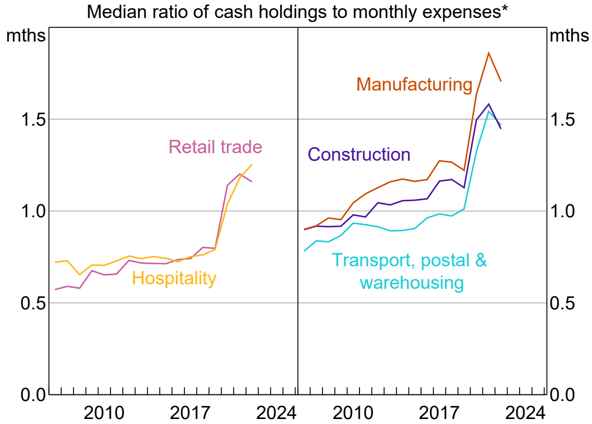
Cash buffers are likely to have declined over the past year. Recent bank liaison suggests cash buffers for small and medium businesses have declined further over the past year and returned to pre-pandemic levels, as challenging economic conditions have persisted. This implies that small businesses have less capacity to withstand future shocks.

Cash buffers tend to be lower for industries whose cost structure is more flexible (Graph 14). Industry differences possibly reflect different operating structures, with businesses in some industries like hospitality and retail trade typically having more ability to adjust their operating expenses, especially via employment.

Graph 14

Small Business Cash Buffers by Industry

Median ratio of cash holdings to monthly expenses*



* Small companies are those with 5–19 full-time employees. Measure of cash holdings constructed by subtracting inventories and accounts receivable from current assets as reported in annual company tax returns. Latest observation June 2022.

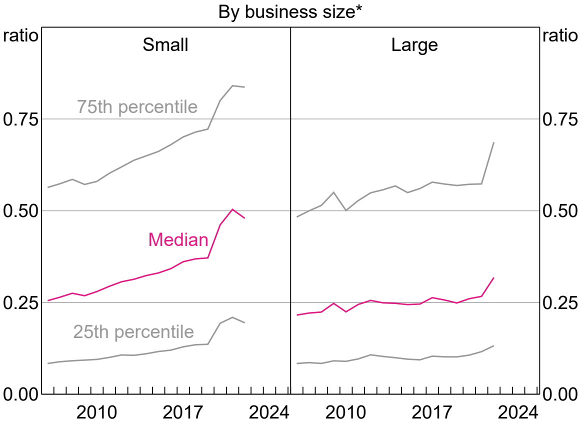
Sources: ABS (BLADE); RBA.

Small businesses tend to keep a higher share of their total assets as cash compared with large businesses (Graph 15) (La Cava and Windsor 2016). This cash ratio has been increasing for small businesses since the early 2010s, while remaining stable for most large businesses. These high and increasing cash ratios are likely to reflect the importance of internal funding for small businesses, given that they typically experience greater difficulty in accessing external sources of funding (as discussed above). During the pandemic, small businesses experienced the largest increase in cash ratios across the distribution, with the median cash ratio peaking at around half in 2021.

Graph 15

Business Cash Holdings to Total Assets

By business size*



* Small companies are those with 5–19 full-time employees; large 200+. Cash holdings estimated by subtracting inventories and accounts receivable from current assets. Latest observation June 2022.

Sources: ABS (BLADE); RBA.

There is little information available on leverage among small businesses. Aggregate business leverage, however, has declined over the past decade and liaison suggests that many small businesses entered the recent tightening cycle with low gearing.

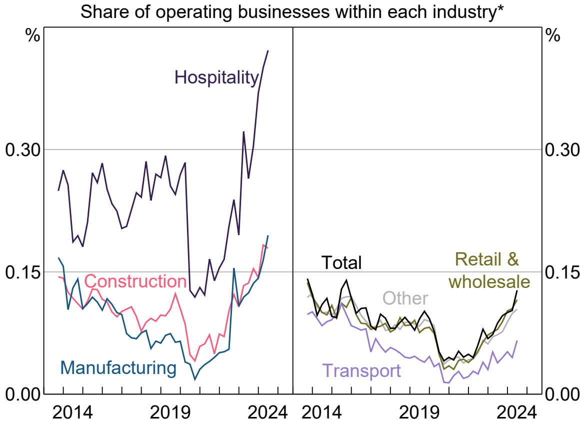
Some small businesses have faced severe financial pressures and entered insolvency

The number of companies entering insolvency has increased sharply over the past couple of years, and at least three-quarters have been small businesses. However, insolvencies remain less than 0.15 per cent of all operating businesses each quarter, similar to pre-pandemic levels (Graph 16, right panel). Insolvencies in the construction and hospitality sectors have driven much of the increase in insolvencies and are above pre-pandemic levels as a share of businesses in these industries (Graph 16, left panel). For the hospitality sector, this is consistent with the acute pressure on revenues and profitability described above. In the past few months, the total number of construction companies entering insolvency has begun to ease but they remain elevated – particularly among sub-contractors, who have been affected by builder insolvencies, rising costs, weather delays and labour shortages (RBA 2024a).

Graph 16

Company Insolvencies by Industry

Share of operating businesses within each industry*



* Quarterly company insolvencies divided by the number of businesses operating in that industry at the end of the financial year. Company insolvencies is seasonally adjusted. Latest observation June 2024.

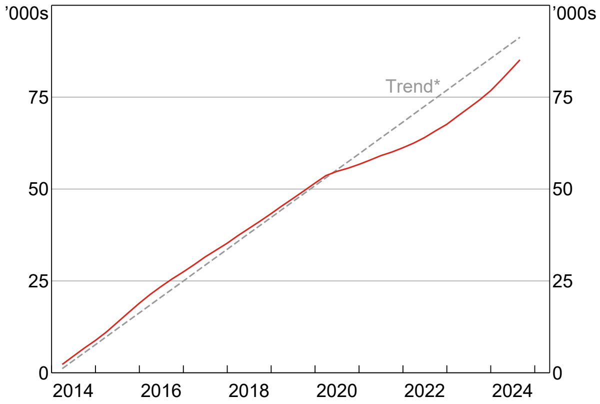
Sources: ABS; ASIC; RBA.

The increase in total insolvencies has been driven by more challenging trading conditions and a catch-up effect following the removal of pandemic-period government support. During the pandemic, the boost to cash buffers from the significant government support and ATO pausing tax collections eased immediate cash flow challenges for many small businesses. As these measures have been unwound over the past two years (including the ATO resuming enforcement actions on unpaid taxes) and economic conditions have become more challenging for small businesses, a cohort of unprofitable businesses have depleted buffers and entered insolvency. On a cumulative basis, however, insolvencies remain below their pre-pandemic trend (Graph 17). Additionally, around 20 per cent of recent insolvencies have been small businesses that are in the process of restructuring. Analysis by ASIC on the first cohort of businesses to enter small business restructuring plans in 2021/22 show that most businesses that undergo restructuring eventually resume operating (ASIC 2023).

Graph 17

Company Insolvencies

Cumulative, since 2014



* Trend for cumulative insolvencies calculated using observations from 1999–2019. Latest observation August 2024.

Sources: ASIC; RBA.

Conclusion

The economic environment has been more challenging for small businesses over the past year. Demand has slowed, especially for discretionary goods and services, while costs have continued to grow at an elevated rate. This has put pressure on more small businesses' profitability. Relative to larger businesses, small businesses generally have more variation in their revenues year-to-year and are more likely to experience losses. However, most small businesses have maintained their profit margins and sizable cash buffers built up during the pandemic have been a key source of resilience through more recent challenging conditions. These buffers are declining and an increasing share of businesses have entered insolvency, though the number of insolvencies remains below its pre-pandemic trend on a cumulative basis.

Small businesses' access to finance is highly variable, and many small businesses continue to report difficulty accessing financing on terms that suit their needs. While the 32nd Small Business Finance Advisory panellists described financing conditions as having tightened over the past year, lenders have generally reported little change in lending standards and the cost of small business finance has been little changed.

Looking ahead, pressures on businesses are expected to ease as real household disposable incomes are projected to grow and inflation to ease. However, given the depletion of buffers and higher sensitivity of small business revenues to the economic cycle, small businesses would be particularly vulnerable to a further deterioration in economic conditions.

Endnotes

* The authors are from Domestic Markets and Financial Stability 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 Australian Small Business and Family Enterprise Ombudsman's (ASBFEO) index of small business operating conditions also remains below the long-term average.

2 The split of total high-growth firms and low-growth firms by industry generally follow the industry's share of total businesses in Australia. Firms in construction and professional, scientific and technical services make up around 40 per cent of high-growth small firms in Australia, slightly above historical proportions.

3 Timely firm-level data on small business expenses is not available.

4 By number of businesses, micro firms – those with less than five employees – account for around 70 per cent of employing businesses. However, as they are very small, they make up a more limited share of employment and output and are typically excluded from our analysis of small businesses.

5 Data on business lending by business size are compiled based on monthly returns collected by the Australian Prudential Regulation Authority (APRA) from banks and registered financial corporations that have $2 billion of business credit or more. This threshold captures over 95 per cent of total business credit. Small and medium business loans are those defined as 'SME retail' or 'SME corporate' respectively in APRA's Prudential Standards APS 112 and APS 113, corresponding to businesses with less than $75 million in consolidated annual revenues. Loans are 'SME retail' if they are in the form of a small business lending facility and the total exposure from the lender to the borrower is less than $1.5 million.

6 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).

References

ASIC (Australian Securities and Investments Commission) (2023), 'Review of Small Business Restructuring Process', Report No 756, January.

Banjo Loans (2024), 'SME Compass Report 2024', May.

Chan P, A Chinnery and P Wallis (2023), 'Recent Developments in Small Business Finance and Economic Conditions', RBA *Bulletin*, September.

Jones B (2024), 'Financing SME Innovation in Australia – Challenges and Opportunities', Speech at COSBOA National Small Business Summit, Sydney, 4 April.

La Cava G and C Windsor (2016), 'Why Do Companies Hold Cash?', RBA Research Discussion Paper No 2016-03.

Majeed O, A Balaguer, D Hansell, L Hendrickson, A Latcham and T Satherley (2021), 'What Drives High Growth? Characteristics of Australian Firms', *Economic Record*, 97(318), pp 350–364.

NAB (2024), 'NAB SME Business Survey: Quarter 4 2023', Report, February.

RBA (Reserve Bank of Australia) (2024a), *Financial Stability Review*, September.

RBA (2024b), *Statement on Monetary Policy*, August.

Xero (2024), 'Small Business Insights', June.

BLADE Disclaimer