National Australia Bank

Quarterly SME Survey — December quarter 2012

SME confidence & conditions weaken a touch in Q4 and poor relative to history; sentiment and activity of SMEs a touch weaker than their larger counterparts. Forward indicators remain subdued implying little upturn in near-term activity. Weakness in manufacturing, retail, wholesale and construction a consistent theme across SMEs and larger firms.

- SMEs business confidence weakened a touch in the December quarter and remained well-below average levels. Confidence was slightly weaker than levels reported by larger businesses in the NAB Quarterly Business Survey. The weak tone of SMEs suggests that interest rate cuts towards the end of 2012 have done little to ease business concerns about the soft state of the local economy. Also, uncertainty about the outcome of the US 'fiscal cliff' (which was not resolved at the time of the survey) and the global growth outlook are likely to have weighed on sentiment.
- SME business conditions weakened in line with confidence in the December quarter. The deterioration was broadly based across all SMEs, though smaller firms continued to under perform their larger counterparts. The deterioration in activity reflected declines in profitability and employment, while trading conditions were unchanged. Forward indicators of demand, although improving, remained poor, especially forward orders and stock levels. Furthermore, while capacity utilisation lifted marginally in the quarter, it remained close to record lows and below that reported by larger firms.
- Responses to a special question suggest that almost two thirds of all respondents developed or improved their websites over the past 12 months, while more than half of firms launched new products to try to strengthen their position among their competitors.
- By industry, confidence fell back sharply in finance, while it also weakened notably in accommodation, cafes & restaurants and wholesale. Health services and manufacturing were the only industries to report improved sentiment in the quarter. Confidence was especially weak in wholesale, finance and manufacturing, while property services was the only industry to report positive sentiment – possibly reflecting generally lower borrowing costs. By state, confidence was poor across all states except WA, where it was marginally positive.
- Conditions in property services, manufacturing, finance and health services deteriorated heavily in the December quarter, while modest improvements were reported in wholesale and retail – albeit activity in these industries was still very poor. SME conditions were weakest in manufacturing, retail, wholesale, construction and property services, while they were least subdued in transport, health and business services. Conditions weakened considerably in WA and SA, while they were modestly better in Queensland and unchanged in Victoria and NSW.
- SME confidence modestly weaker for low-tier ($2-3m p.a.) and mid-tier firms ($3-5m p.a.) and unchanged for high-tier firms ($5-10m p.a.). Conditions weakened across all firm sizes to poor levels, with activity of the smaller SMEs (low-tier and mid-tier firms) especially weak in the quarter.

Key quarterly business statistics**

	2011q4	2012q3	**2012q4**		2011q4	2012q3	**2012q4**
		Net balance				*Net balance*	
SME business confidence	-3	**-5**	**-7**	SME trading conditions	-3	**-3**	**-3**
Low	-6	**-3**	**-6**	Low	-10	**-8**	**-8**
Mid	-4	**-3**	**-5**	Mid	5	**-5**	**-5**
High	1	**-7**	**-7**	High	-3	**0**	**1**
SME business conditions	-3	**-5**	**-7**	SME profitability	-6	**-9**	**-12**
Low	-8	**-8**	**-9**	Low	-12	**-11**	**-13**
Mid	2	**-5**	**-8**	Mid	1	**-9**	**-11**
High	-5	**-3**	**-4**	High	-8	**-8**	**-11**
SME cash flows (n.s.a.)	1	**-3**	**-2**	SME employment	-2	**-3**	**-5**
Low	-5	**-6**	**-4**	Low	-2	**-5**	**-5**
Mid	2	**-7**	**-10**	Mid	1	**-4**	**-9**
High	4	**2**	**5**	High	-3	**-2**	**-3**

Low: $2-3m p.a. Mid: $3-5m p.a. High: $5-10m p.a.

** Data are seasonally adjusted by NAB, except SME cash flow (insufficient time series available). All data are net balance indexes. Fieldwork for this Survey was conducted from 19 Nov to 7 Dec 2012 covering over 700 SME firms across the non-farm business sector.

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Next release:
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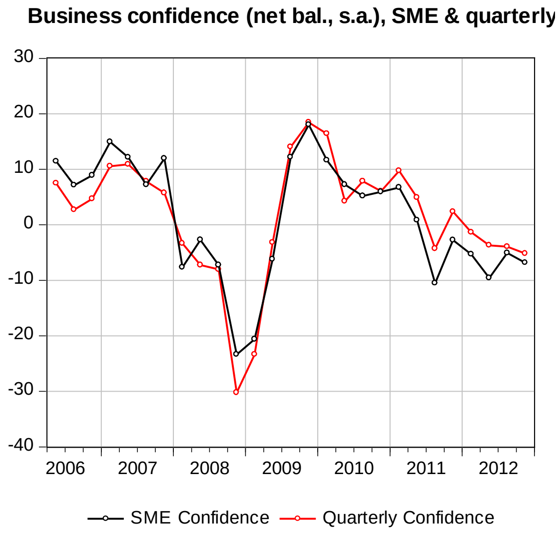
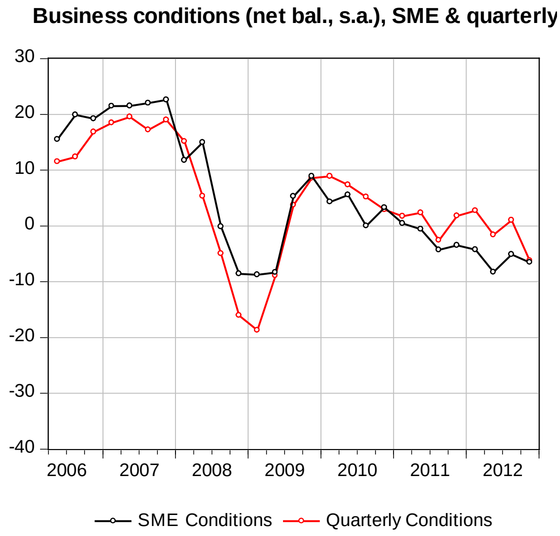
Analysis

Confidence falters and consistent with larger firms



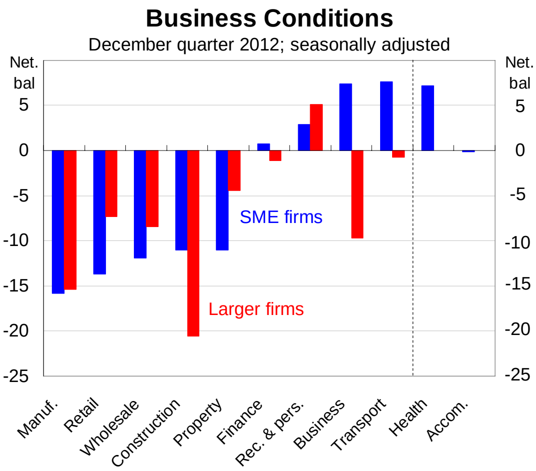
Conditions also soften and remain subdued



SME business confidence faltered in the December quarter – down 2 points to -7 index points – though remained above the very poor level reported mid-way through the year (-10 points). While confidence of SMEs remains below that of their larger counterparts (as the survey has shown for the past two years), the gap has narrowed and pessimism seems a common theme. The deterioration in confidence may partly reflect the persistent weakness in forward looking indicators highlighted by the survey; employment conditions weakened further in the quarter while forward orders and capacity utilisation remained lacklustre. The deterioration in confidence may also reflect some concern about international factors – markets were heavily focussed on the US 'fiscal cliff' at the time the survey was conducted, while commodity prices had softened considerably, sparking concern about the longevity of Australia's mining investment boom. The RBA lowered the cash rate by 25 bps at its December meeting, with this meeting taking place during the period the survey was conducted. Low-tier and mid-tier firms lost confidence in the December quarter, while confidence was unchanged at a particularly poor level for high-tier firms.

SME business conditions also deteriorated in the December quarter – down 2 points to -7 index points – and remained well below the series average (of +5 points since mid-2006). Business conditions of larger firms weakened more sharply than they did for SMEs in the December quarter, with activity now broadly similar across all firms (see Graph).

SME's very weak in manufacturing & retail; holding up in health

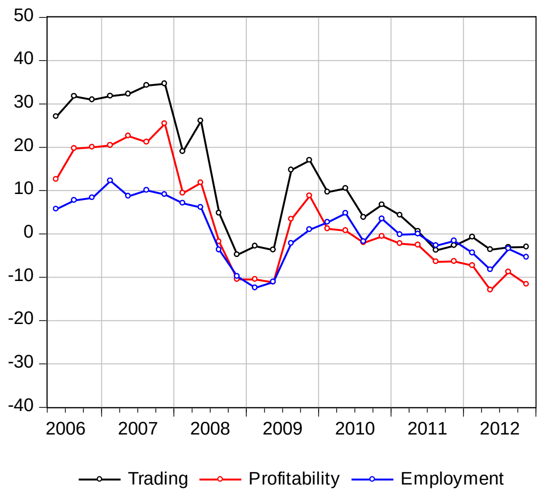


A comparison of industry conditions for SMEs and larger sized firms (taken from NAB's Quarterly Business Survey) suggests that SMEs generally under performed larger firms in the December quarter. Business services and transport were the clear exceptions to this – possibly reflecting larger firms in these industries having a greater exposure to overseas weakness – while larger construction firms also appear to be doing it extremely tough compared to SMEs. A consistent theme across all firm sizes was the relative (albeit fading) strength in recreation & personal services and relative weakness in manufacturing, retail, wholesale and construction.

Analysis (cont.)

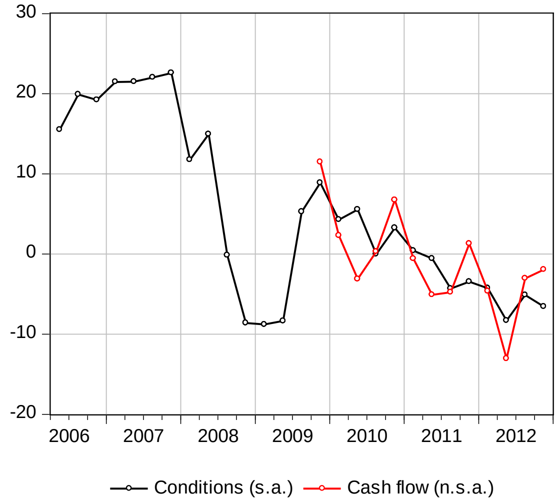
Profits & employment fall back

SME business conditions components (net bal., s.a.)



Cash flows strengthen but still poor

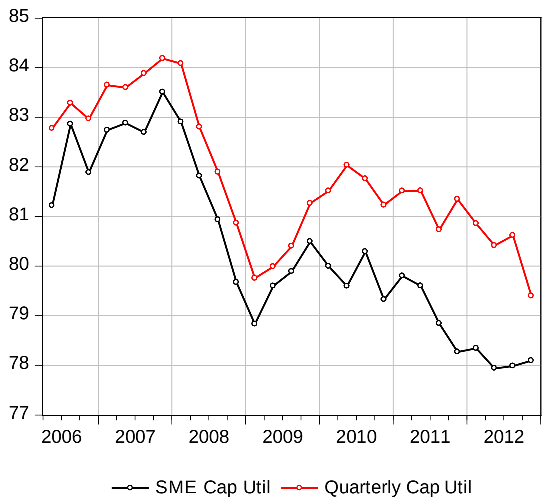
SME business conditions & cash flow (net bal.)



The weakening in SME business conditions reflected modest falls in profitability and employment conditions, while trading conditions were unchanged at a less subdued level relative to profitability and employment. SME cash flows (n.s.a.) strengthened a little, after improving considerably in the previous quarter, though they remain in contractionary territory.

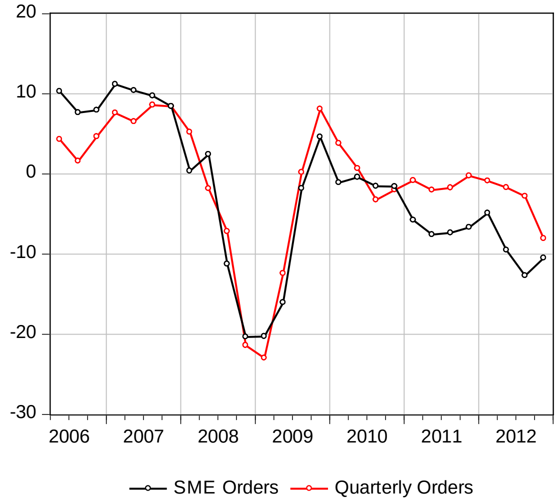
Plenty of spare capacity

Capacity utilisation (per cent, s.a.), SME & quarterly



Orders improve but still very weak

Forward orders (net bal., s.a.), SME & quarterly

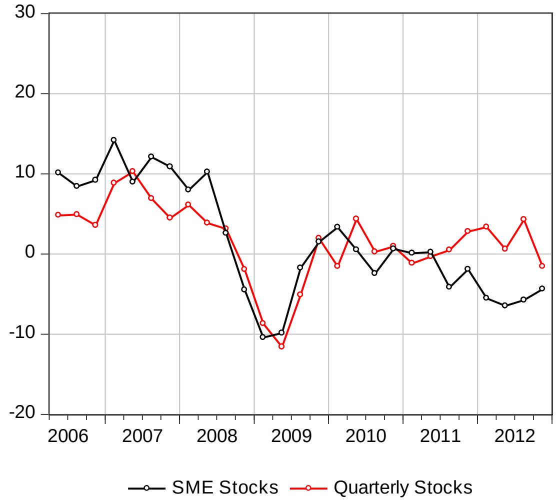


Capacity utilisation rose marginally in the December quarter – up 0.1 ppt to 78.1%. Despite the marginal rise, the overall level of SME capacity utilisation remains close to historically low levels for this survey (since mid 2006) and well below the level of utilised capacity of larger firms (79.4%), implying there is still plenty of slack in the economy. The marginal pick up reflected a solid increase in utilised capacity of high-tier firms (up 1 ppt to 79.1%) and a marginal rise for mid-tier firms (up 0.2 ppts to 77.7%), while low-tier firms experienced an overall reduction in capacity utilisation in the December quarter (down 0.5 ppts to 77.1%). Forward orders of SMEs improved moderately in the quarter, after falling heavily in the previous quarter. Despite the improvement, SME forward orders were still very weak and they remained below those of their larger counterparts, which were also particularly weak.

Analysis (cont.)

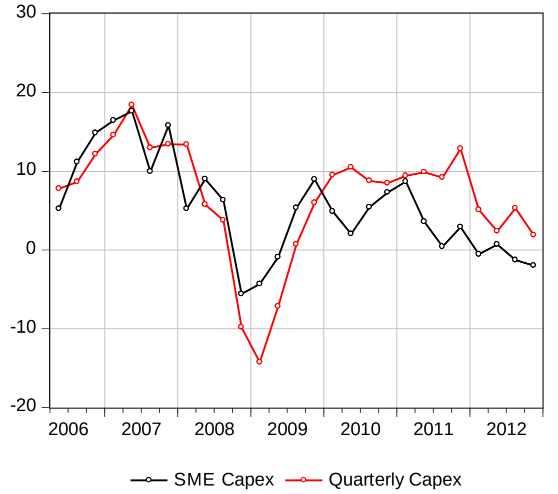
Stocks levels trending higher..

Stocks (net bal., s.a.), SME & quarterly



..but SME investment dwindles

Capital expenditure (net bal., s.a.), SME & quarterly

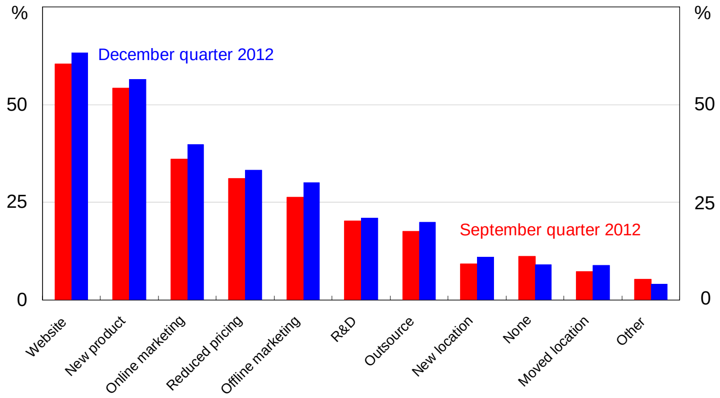


The SME stocks index edged higher in the December quarter, which is interestingly at odds with a sharp fall in stocks recorded for larger firms over the same period. The sharp dip in stocks of larger firms was consistent with a large deterioration in trading conditions; SME firms have typically experienced weaker trading conditions than larger firms over recent quarters and appear to have already adjusted their stock levels lower in response to this. The variation in trading conditions of larger and smaller firms seems to explain the difference in stocks of each. Capital expenditure softened marginally in the December quarter. Larger firms also reported a softening in capital expenditure in the quarter, though this was more pronounced likely reflecting some pull back in mining investment (not captured by the SME survey) in response to the weaker global outlook.

A majority of firms continue to increase their online presence to boost their competitiveness in the market

Strategies employed over past 12 months to improve competitiveness

Proportion of firms*

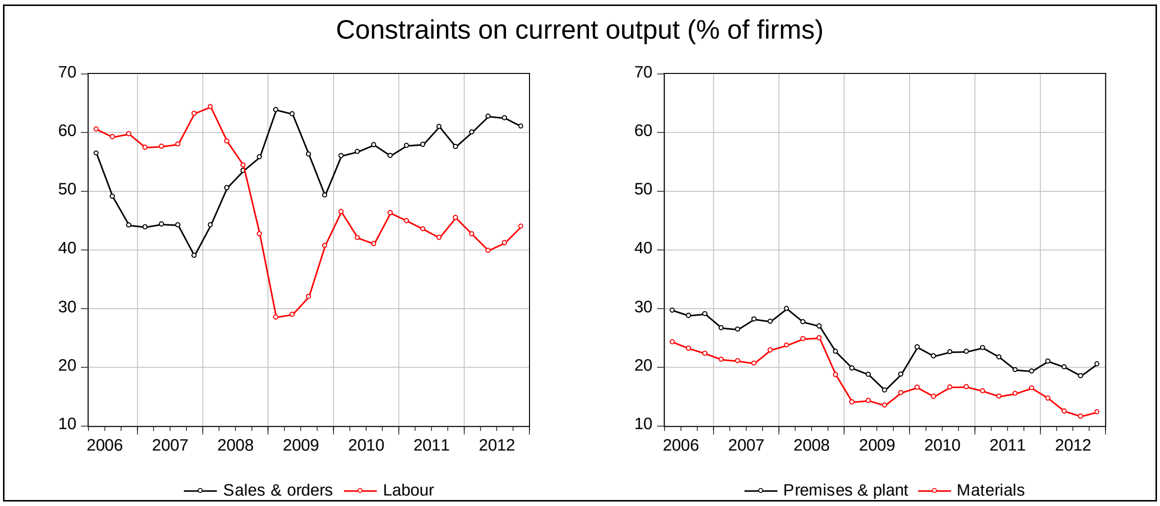


* Multiple responses allowed; will not sum to 100%
Source: NAB Quarterly SME Survey

In the December Quarter SME Survey, we again asked firms whether they had employed any new strategies over the past 12 months in an attempt to improve competitiveness in the market. The results show that firms employed more strategies in all categories (with the exception of 'other') over 2012 compared to in the year to September quarter 2012. However, the overall results were little changed from the September quarter outcomes. The results show that almost two thirds of all respondents developed or improved their websites, while more than half of firms launched new products to try to strengthen their position among their competitors (see Graph). It is also evident that a larger share of firms employed online marketing strategies than offline advertising strategies – a possible sign that internet marketing may be becoming increasingly more common than more traditional forms of advertising. Only a small proportion of respondents either moved or opened new locations to try to improve competitiveness.

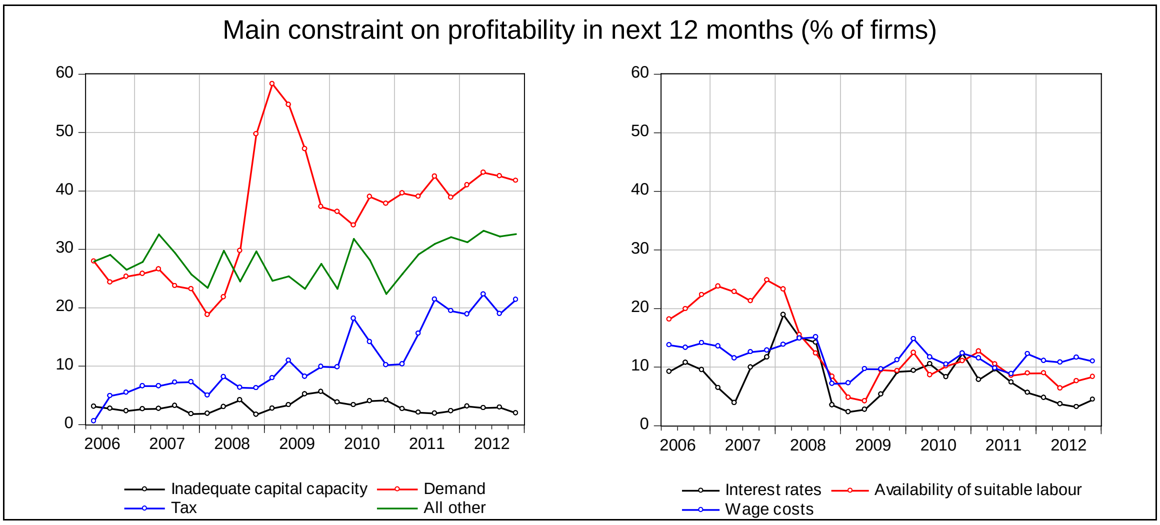
Analysis (cont.)

Sales and orders still main constraint on output



Despite softening marginally, sales & orders remain the most constraining factor on the output of SMEs in the December quarter – consistent with the weakness in forward looking indicators of demand (including forward orders, stocks and capacity utilisation). SMEs reported a modest increase in the significance of availability of suitable labour as a constraining factor on output. This may reflect the frictional adjustment taking place within the economy which is making it more difficult to match job vacancies with suitably skilled labour. Interestingly, labour availability appears to be more of an issue for smaller firms than for their larger counterparts. Nonetheless, the labour market remains in a soft patch at present and the difficulty of obtaining suitable labour appears fairly benign for all firms sizes compared to pre-GFC levels. The importance of premises & plant and materials as constraints lifted slightly, but remained low overall, which was broadly similar to those of larger firms.

Profitability expected to be constrained by a lack of demand; interest rates and lack of capacity less important

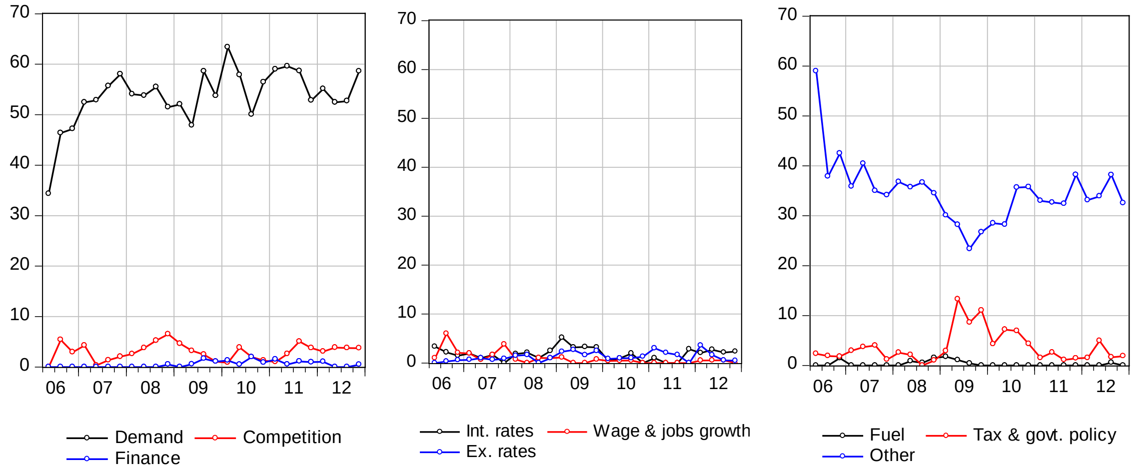


In the December quarter, lack of demand remained the number one factor expected to constrain profitability over 2013. The proportion of firms worried about the impact of demand on profits has gradually risen since mid-2010, though it remains far less of a concern than it was immediately after the GFC hit. The proportion of firms concerned about the impact of changes to tax policy on future profitability continued to climb in the quarter, and remains well above levels just two years earlier. While interest rates were marginally more concerning in the quarter, they remain relatively insignificant overall – it should be noted that some of the survey participants will have responded prior to the RBA lowering the cash rate by 25 bps to 3.0% in December 2012. The availability of suitable labour and wage costs also appeared of little concern to business.

Analysis (cont.)

Demand driving improvement in trading performance – interest and exchange rates providing little assistance

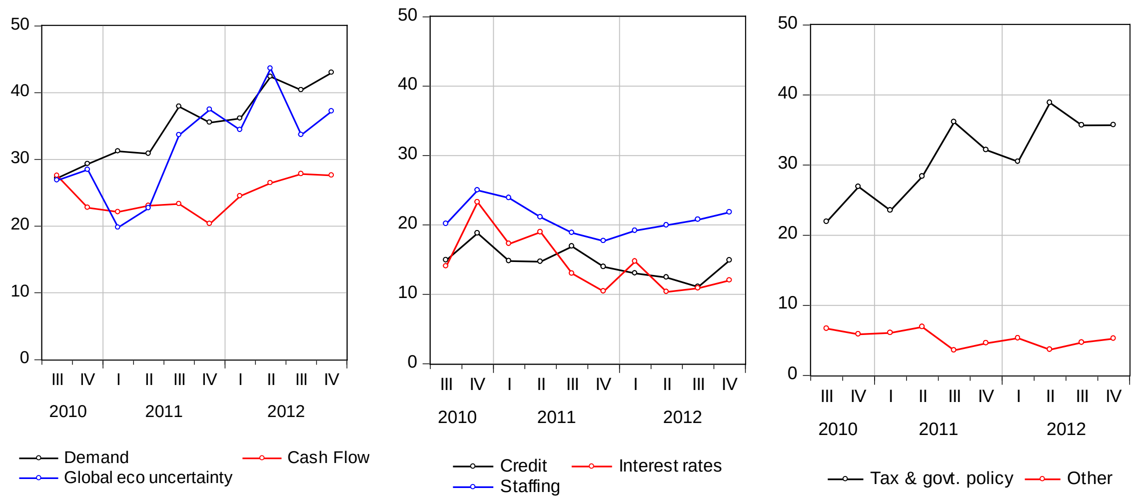
Main reason for improvement in trading performance (net balance)



While trading performance remained fairly lacklustre in the December quarter, overall trading continued to be supported by demand, with the proportion of firms noting this as a driver lifting firmly in the quarter. “Other” reasons as a contributing factor to improved trading fell back in the quarter though remained reasonably significant overall; the significance of this factor largely reflects seasonal and company specific factors. Tax & government policy appear to have provided very little support to trading performance in the December quarter, with businesses likely to be affected by the tight stance of fiscal policy.

SMEs constrained by a lack of demand and global economic uncertainty

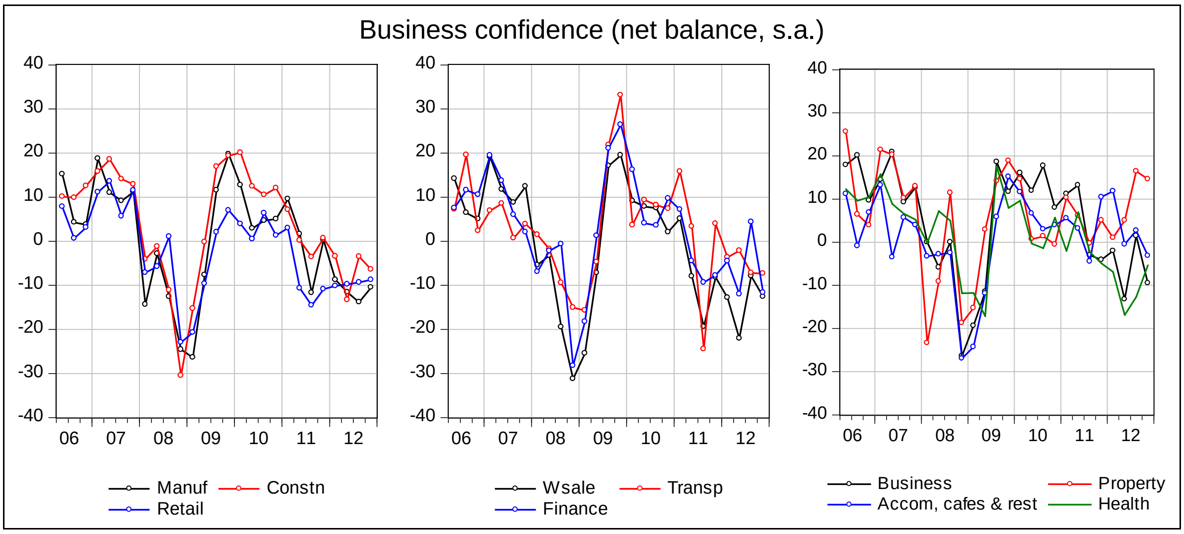
Most significant constraining factors for SMEs (per cent, multiple response)



The ability of SMEs to make longer term decisions remained most constrained by demand in the December quarter, with this factor increasing in significance in the quarter. A larger proportion of firms also indicated global economic uncertainty as a significant constraint, with this factor remaining a considerable factor overall, closely followed by tax & government policy. While the availability of suitable staff, availability of credit and interest rates all became slightly more constraining in the quarter, they remained relatively less significant.

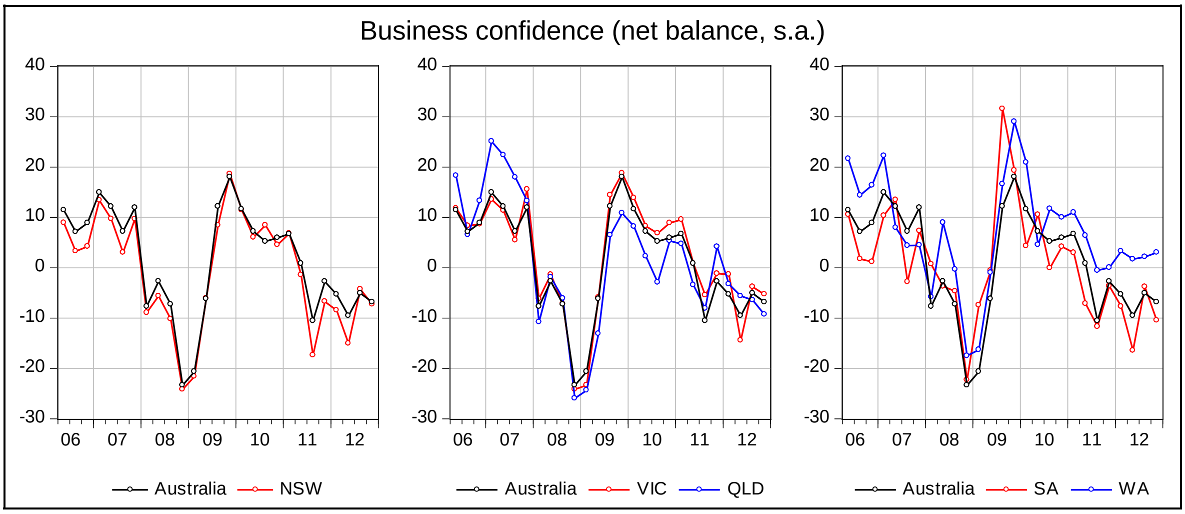
Industry and State analysis

Property the only optimistic industry; wholesale & finance very pessimistic



Business confidence generally eased across all industries in the December quarter; health and manufacturing were the only industries to report better confidence in the quarter, while retail and transport confidence was unchanged. Business confidence deteriorated heavily in finance services (down 16 to -12 points), entirely unwinding a significant rise in the previous quarter, while confidence also fell back notably in accommodation, cafes & restaurants and wholesale. Property services remained the most optimistic industry in the December quarter, reporting the only positive net balance reading (+15) – the strength in property sentiment may reflect historically low interest rates, despite the general lack of confidence in the property market. The least confident industries include wholesale (-13), finance services (-12) and manufacturing (-10).

Business confidence falters across all mainland states, except WA, which remained more upbeat

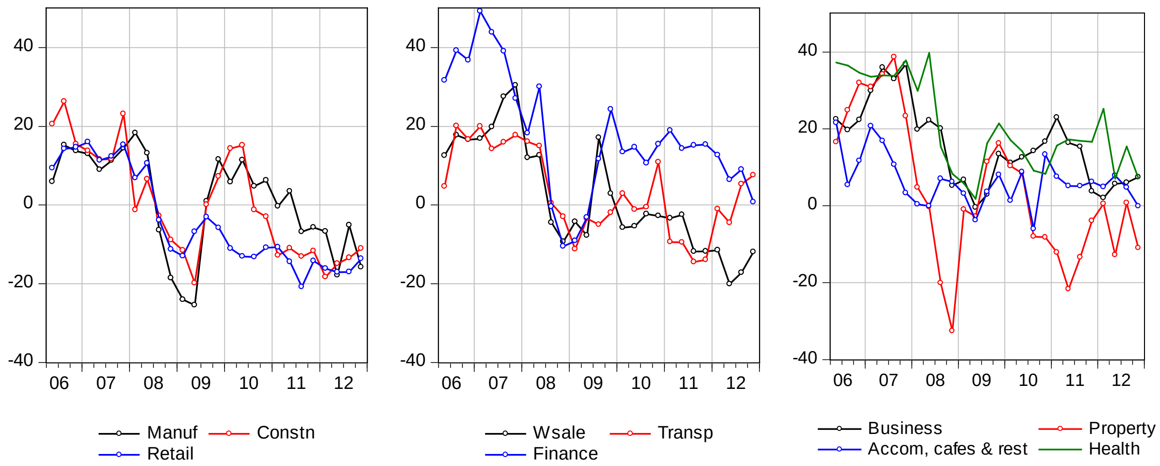


Business confidence deteriorated across all mainland states in the December quarter, with the exception of WA, where it improved marginally; WA was also the only state to report a positive confidence reading in the quarter. The most notable falls were in SA (down 6), followed by Queensland and NSW (both down 3). The overall level of SME business confidence was strongest in WA (+3), while it was weakest in SA (-10), Queensland (-9) and NSW (-7).

Industry and State analysis (cont.)

Conditions strongest in transport, health and business; weakest in manufacturing and retail

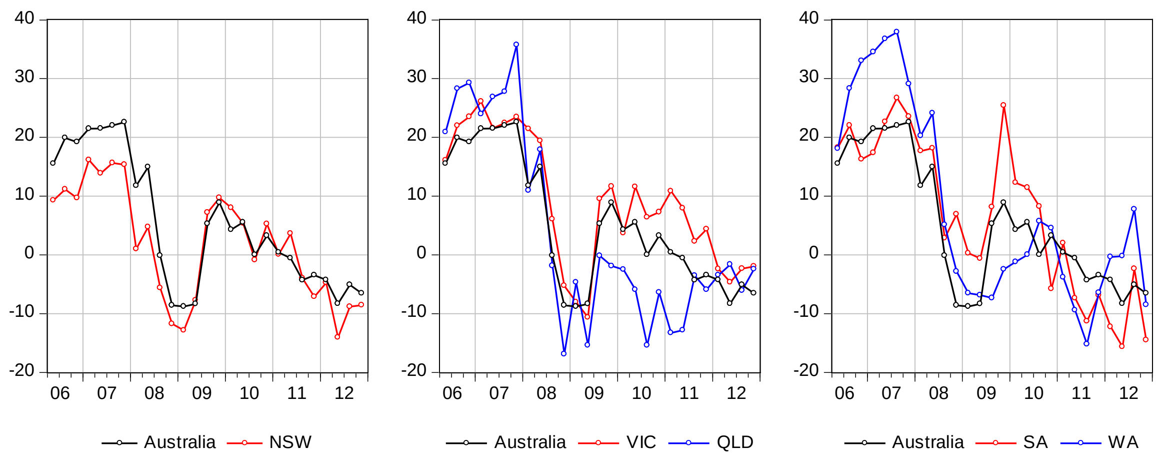
Business conditions (net balance, s.a.)



Changes in business conditions were somewhat mixed across industries in the December quarter; a number of industries reported solid falls in the quarter, while some industries reported (fairly marginal) improvements. Business conditions deteriorated significantly in property services (down 12), manufacturing (down 11), finance services and health (both down 8), while they were a touch better in wholesale (up 5), retail, transport (both up 3) and construction (up 2). While confidence held up strongly in property services, this may simply reflect an expectation for activity to improve from currently low levels, rather than a solid pick up in activity in coming quarters. The strongest performing industries in the quarter were transport (+8), health and business services (both +7), while conditions were weakest in manufacturing (-16), retail (-14), wholesale (-12), construction and property services (both -11).

Conditions very subdued in all states, with particular weakness in SA and NSW

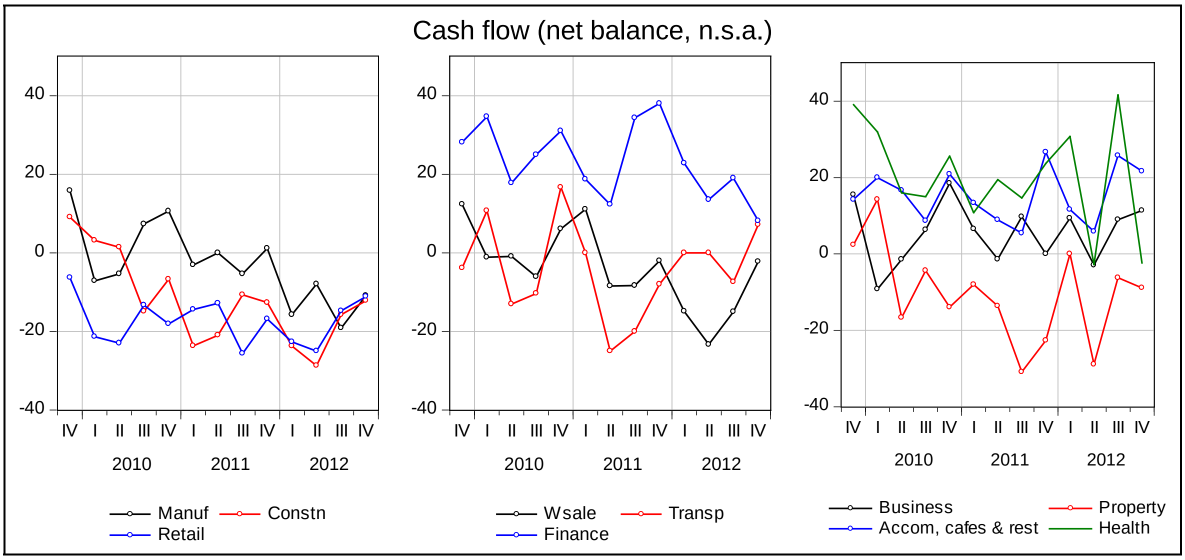
Business conditions (net balance, s.a.)



Business conditions deteriorated very sharply in WA (down 16) and SA (down 12) in the December quarter, which may be a side effect of the recent pull back in mining investment, which will indirectly affect a number of SME firms either operating in mining regions or supporting mining operations. Conditions actually improved moderately in Queensland, while they were unchanged in NSW and Victoria. In levels terms, conditions of SMEs were least subdued (albeit still negative) in Victoria and Queensland (both -2), while they were weakest in SA (-12), NSW (-9) and WA (-8).

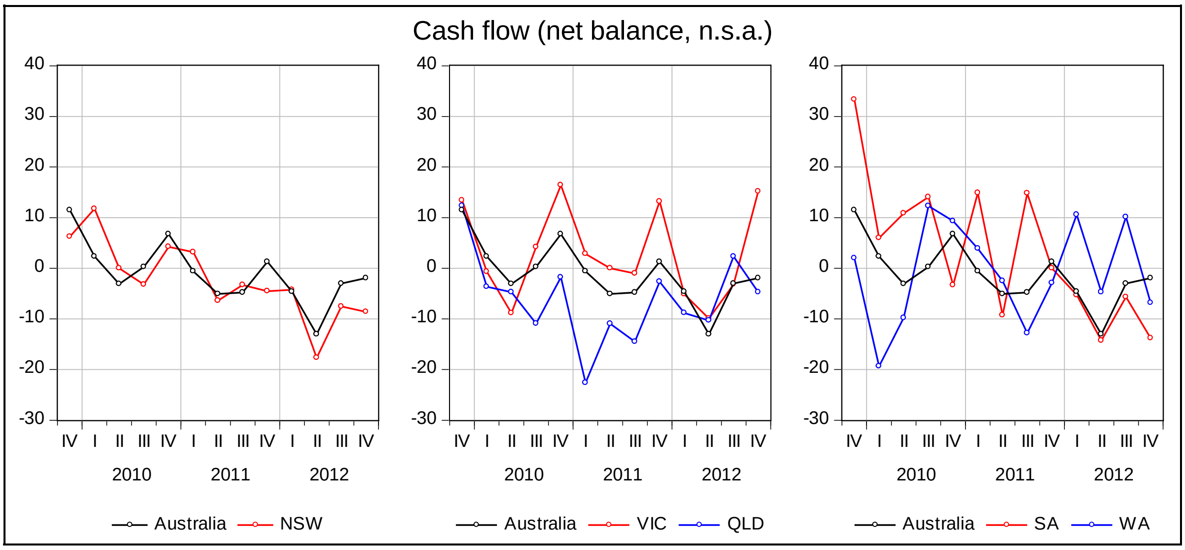
Industry and State analysis (cont.)

Cash flows strongest in accommodation; very weak in manufacturing, retail and construction



Overall cash flows (not seasonally adjusted) improved in the December quarter, driven by improvements in wholesale, transport, manufacturing, business services, retail and construction cash flows. However, this was partly offset by a very sharp decline in cash flows in health services, entirely unwinding a very sharp improvement in the previous quarter. Cash flows also eased back in finance, property services and accommodation, cafes & restaurants. In levels terms, the cash flow index was highest in accommodation, cafes & restaurants and business services, while it was lowest in manufacturing, construction and retail – consistent with weak activity in these industries.

Cash flows up sharply in Victoria, where they were strongest; cash flows deteriorate everywhere else

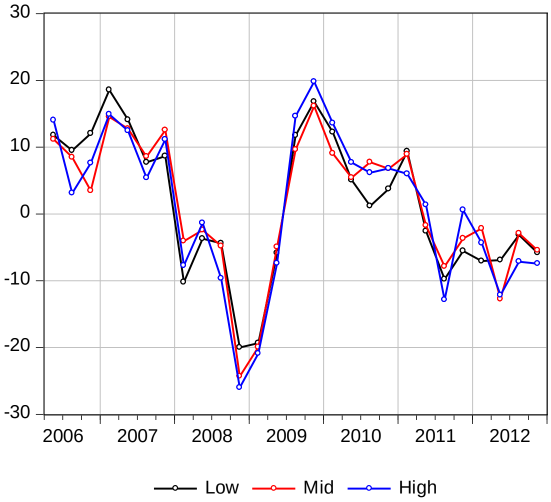


The rise in overall cash flows (not seasonally adjusted) in the December quarter entirely reflected a significant rise in Victoria, though part of the rise appears to have been seasonal, with cash flows in Victoria exhibiting a similar pattern in the same quarter of previous years. Cash flows deteriorated across all other states in the quarter, with particularly solid declines reported in WA and SA – consistent with sharp falls in activity in these states. In levels terms, cash flows were strongest (and positive) in Victoria, while they were weakest in SA and NSW.

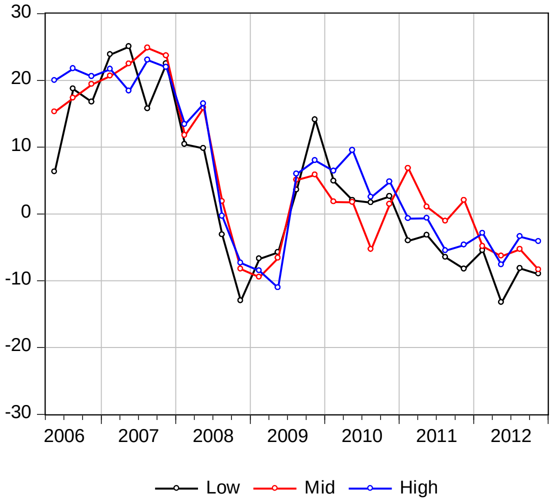
Firm size analysis

Confidence and conditions generally worsen across SMEs

Business confidence (net bal., s.a.)



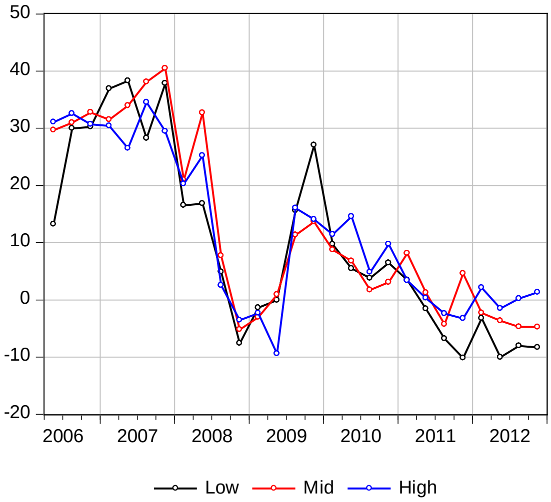
Business conditions (net bal., s.a.)



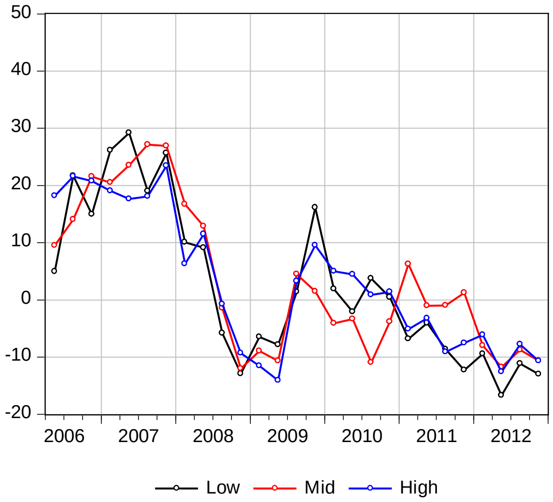
Variations in business confidence across all SME firm sizes narrowed in the December quarter, with the previously least pessimistic low-tier ($2-3m p.a.) and mid-tier ($3-5m p.a.) SMEs reporting a deterioration in confidence, while confidence of the more pessimistic high-tier firms ($5-10m p.a.) was unchanged. Confidence of SMEs across firm sizes is now within the range of -7 to -5 index points, with high-tier SMEs remaining the most pessimistic overall. The general softening in confidence in the quarter is consistent with a softening in business conditions, with activity softening across all firm sizes. In levels terms, conditions were weakest for low-tier firms, closely followed by mid-tier firms, while they were relatively better for high-tier firms, albeit still weak. The overall deterioration in SME conditions was driven by further weakness in profitability and employment conditions.

Trading conditions stabilising but profitability weakens across SMEs

Trading conditions (net bal., s.a.)



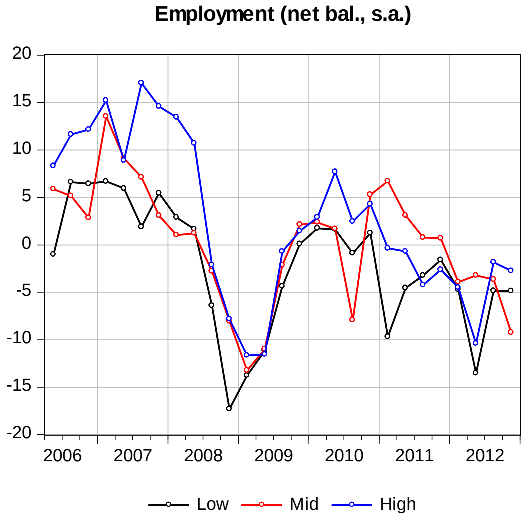
Profitability (net bal., s.a.)

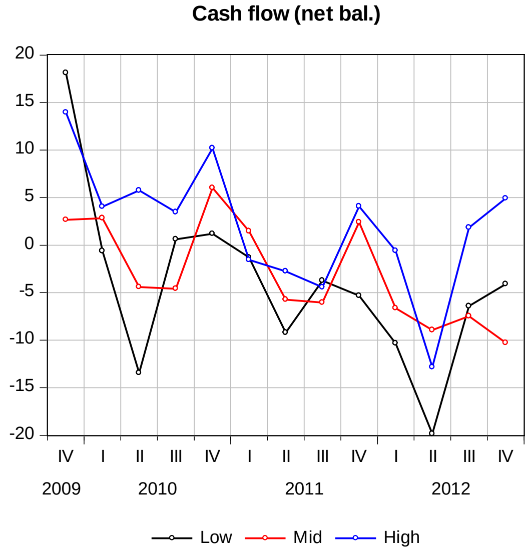


Trading conditions appear to have stabilised at low levels across all SMEs in late 2012, following two years of general decline. Within the quarter, high-tier SMEs saw a marginal improvement in trading, while low-tier and mid-tier reported no change. In levels terms, trading performance remained most subdued in low-tier firms, while it was relatively stronger (and slightly positive) for high-tier firms. While trading conditions appear to have stabilised somewhat in the December quarter, the same cannot be said for profitability; all SMEs reported a deterioration in profitability in the quarter, partly unwinding broad-based improvements in the September quarter. Profitability remained relatively similar (and weak) across all SME firm sizes, and worryingly in line with GFC levels.

Firm size analysis (cont.)

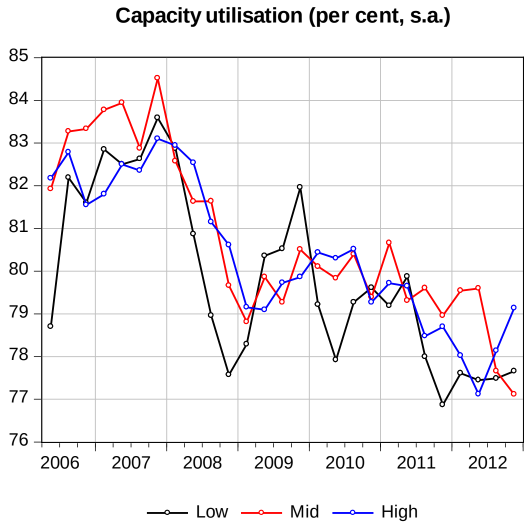
Employment conditions and cash flows of mid-tier firms falter

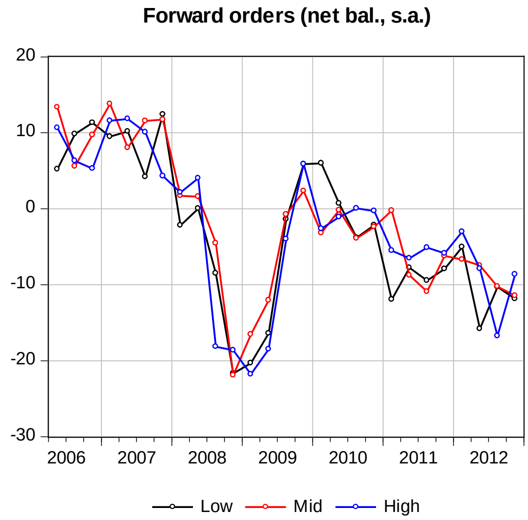




Employment conditions deteriorated heavily for mid-tier firms in the December quarter, consolidating a general decline in labour market activity over the previous two years. However, employment conditions of low-tier and high-tier firms were broadly unchanged. Consistent with these quarterly movements, employment conditions were weakest for mid-tier firms, while they were least subdued for high-tier and low-tier firms. Changes in cash flows were mixed across SME firm sizes in the quarter, though were fairly consistent with employment outcomes. Cash flows of high-tier and low-tier firms improved modestly, while they deteriorated a touch for mid-tier firms. In levels terms, cash flows were strongest for high-tier firms, with larger SMEs having bounced back reasonably well since mid-2012. Low-tier SMEs also experienced a similar sized recovery in cash flows over the second half of 2012, though they started from a lower base so the overall level remains below that of high-tier firms. Mid-tier firms' cash flows were weakest overall.

Capacity utilisation and forward orders strengthen solidly for high-tier firms, but mid-tier firms report further declines





Forward indicators of demand for high-tier firms appear to have strengthened, with capacity utilisation and forward orders picking up solidly in the December quarter. However, the outlook for mid-tier firms is not so promising, with capacity utilisation falling to its lowest level in the history of the survey, and forward orders deteriorating to the lowest level since June quarter 2009. Forward looking indicators for low-tier firms were a little more mixed, with capacity utilisation picking up marginally – albeit still very low – and forward orders softening slightly in the quarter.

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